UNIVERSITY OF PENNSYLVANIA

THE WHARTON SCHOOL

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Professor Martin Sikora Spring 1997

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WHARTON REPROGRAPHICS

1

Strategic analysis for more profitable acquisitions

A seller's market demands more careful evaluation than ever before

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Alfred Rappaport

As more and more corporations see acquisitions and mergers as an important part of their growth strategy, the acquisitions market has become intensely competitive, and buyers are paying a substantial premium for target companies. This author describes a framework for acquisitions analysis that evaluates both the buying and the selling company and helps the buyer decide, among other things, the maximum price he should pay for a particular company as well as the best way to finance the acquisition.

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Less than a decade after the frantic merger activity of the late 1960s, we are again in the midst of a major wave of corporate acquisitions. In contrast to the 1960s, when acquirers were mainly freewheeling conglomerates, the merger movement in the 1970s includes such long-established giants of U.S. industry as General Electric, Gulf Oil, and Kennecott Copper. Because of the decline in the value of the dollar and the greater political stability of the United States, foreign companies also have become increasingly active buyers of U.S. companies during the past few years.

Most acquisitions are accomplished with cash today, rather than with packages of securities as was common in the 1960s. Finally, the current merger movement involves the frequent use of tender offers that often lead to contested bids and to the payment of substantial premiums above the premerger market value of the target company. In 1978, cash tender offer premiums averaged more than 70% above premerger market values.

The popular explanation for the recent merger rage is that the market is "undervaluing" many solid companies, thus making it substantially cheaper to buy rather than to build. Couple this belief with the fact that many corporations are enjoying relatively strong cash positions and the widely held view that government regulation and increased uncertainty about the economy make internal growth strategies relatively unattractive, and we see why mergers and acquisitions have become an increasingly important part of corporate growth strategy.

Despite all of the foregoing rationale, more than a few of the recent acquisitions will fail to create value for the acquirer's shareholders. After all, shareholder value depends not on premerger market valuation of the target company but on the actual

acquisition price the acquiring company pays compared with the selling company's cash flow contribution to the combined company.

Only a limited supply of acquisition candidates is available at the price that enables the acquirer to earn an acceptable return on investment. A well-conceived financial evaluation program that minimizes the risk of buying an economically unattractive company or paying too much for an attractive one is particularly important in today's seller's market. The dramatic increase in premiums that must be paid by a company bidding successfully calls for more careful analysis by buyers than ever before.

Because of the competitive nature of the acquisition market, companies not only need to respond wisely but often must respond quickly as well. The growing independence of corporate boards and their demand for better information to support strategic decisions such as acquisitions have raised the general standard for acquisition analysis. Finally, sound analysis convincingly communicated can yield substantial benefits in negotiating with the target company's management or, in the case of tender offers, its stockholders.

Malcolm S. Salter and Wolf A. Weinhold outlined seven principal ways in which companies can create value for their shareholders via acquisition.[1] In this article, I will show how management can estimate how much value a prospective acquisition will in fact create. In brief, I will present a comprehensive framework for acquisition analysis based on contemporary financial theory—an approach that has been profitably employed in practice. The analysis provides management and the board of the acquiring company with information both to make a decision on the candidate and to formulate an effective negotiating strategy for the acquisition.

Steps in the analysis

The process of analyzing acquisitions falls broadly into three stages: planning, search and screen, and financial evaluation.

The acquisition planning process begins with a review of corporate objectives and product-market strategies for various strategic business units. The acquiring company should define its potential directions for corporate growth and diversification in terms of corporate strengths and weaknesses and assessment of the company's social, economic, political, and technological environment. This analysis produces a set of acquisition objectives and criteria.

Specified criteria often include statements about industry parameters, such as projected market growth rate, degree of regulation, ease of entry, and capital versus labor intensity. Company criteria for quality of management, share of market, profitability, size, and capital structure also commonly appear in acquisition criteria lists.

The search and screen process is a systematic approach to compiling a list of good acquisition prospects. The search focuses on how and where to look for candidates, and the screening process selects a few of the best candidates from literally thousands of possibilities according to objectives and criteria developed in the planning phase.

Finally comes the financial evaluation process, which is the focus of this article. A good analysis should enable management to answer such questions as:

> What is the maximum price that should be paid for the target company?

> What are the principal areas of risk?

> What are the earnings, cash flow, and balance sheet implications of the acquisition?

> What is the best way of financing the acquisition?

Corporate self-evaluation

The financial evaluation process involves both a self-evaluation by the acquiring company and the evaluation of the candidate for acquisition. While it is possible to conduct an evaluation of the target company without an in-depth self-evaluation first, in general this is the most advantageous approach.[2] The scope and detail of corporate self-evaluation will necessarily vary according to the needs of each company.

Two fundamental questions posed by a self-evaluation are: (1) How much is my company worth? (2) How would its value be affected by each of several scenarios? The first question involves generating a "most likely" estimate of the company's value based on management's detailed assessment of its objectives, strategies, and plans. The second question calls for an assessment of value based on the range of plausible scenarios that enable management to test the joint effect of hypothesized combinations of product-market strategies and environmental forces.

Corporate self-evaluation viewed as an economic assessment of the value created for shareholders by various strategic planning options promises potential benefits for all companies. In the context of the acquisition market, self-evaluation takes on special significance.

First, while a company might view itself as an acquirer, few companies are totally exempt from a possible takeover. During 1978 alone, 80 acquisitions exceeding $100 million were announced. The recent roster of acquired companies includes such names as Anaconda, Utah International, Babcock & Wilcox, Seven Up, Pet, Carborundum, and Del Monte. Self-evaluation provides management and the board with a continuing basis for responding to tender offers or acquisition inquiries responsibly and quickly. Second, the self-evaluation process might well call attention to strategic divestment opportunities. Finally, self-evaluation provides acquisition-minded companies a basis for assessing the comparative advantages of a cash versus an exchange-of-shares offer.

Acquiring companies commonly value the purchase price for an acquisition at the market value of the shares exchanged. This practice is not economically sound and could be misleading and costly to the acquiring company. A well-conceived analysis for an exchange-of-shares acquisition requires sound valuations of *both* buying and selling companies. If the acquirer's management believes the market is undervaluing its shares, then valuing the purchase price at market might well induce the company to overpay for the acquisition or to earn less than the minimum acceptable rate of return.

Conversely, if management believes the market is overvaluing its shares, then valuing the purchase price at market obscures the opportunity of offering the seller's shareholders additional shares while still achieving the minimum acceptable return.

Valuation of acquisitions

Recently *Business Week* reported that as many as half of the major acquisition-minded companies are relying extensively on the discounted cash flow (DCF) technique to analyze acquisitions.[3] While mergers and acquisitions involve a considerably more complex set of managerial problems than the purchase of an ordinary asset such as a machine or a plant, the economic substance of these transactions is the same. In each case, there is a current outlay made in anticipation of a stream of future cash flows.

Thus the DCF criterion applies not only to internal growth investments, such as additions to existing capacity, but equally to external growth investments, such as acquisitions. An essential feature of the DCF technique is that it explicitly takes into account that a dollar of cash received today is worth more than a dollar received a year from now, because today's dollar can be invested to earn a return during the intervening time.

To establish the maximum acceptable acquisition price under the DCF approach, estimates are needed for (1) the incremental cash flows expected to be generated because of the acquisition and (2) the cost of capital—that is, the minimum acceptable rate of return required by the market for new investments by the company.

In projecting the cash flow stream of a prospective acquisition, what should be taken into account is the cash flow contribution the candidate is expected to make to the acquiring company. The results of this projection may well differ from a projection of the candidate's cash flow as an independent company. This is so because the acquirer may be able to achieve operating economies not available to the selling company alone. Furthermore, acquisitions generally provide new postacquisition investment opportunities whose initial outlays and subsequent benefits also need to be incorporated in the cash flow schedule. Cash flow is defined as:

(earnings before interest and taxes [EBIT]) × (1-income tax rate) + depreciation and other noncash charges − capital expenditures − cash required for increase in net working capital

In developing the cash flow schedule, two additional issues need to be considered: (1) What is the basis for setting the horizon date—that is, the date beyond which the cash flows associated with the acquisition are not specifically projected? (2) How is the residual value of the acquisition established at the horizon date?

A common practice is to forecast cash flows period by period until the level of uncertainty makes management too "uncomfortable" to go any farther. While practice varies with industry setting, management policy, and the special circumstances of the acquisition, five or ten years appears to be an arbitrarily set forecasting duration used in many

1. Malcolm S. Salter and Wolf A. Weinhold, "Diversification via Acquisition: Creating Value," HBR July-August 1978, p. 166.

2. For a more detailed description on how to conduct a corporate self-evaluation, see my article, "Do You Know the Value of Your Company?" *Mergers and Acquisitions*, Spring 1979.

3. "The Cash-Flow Takeover Formula," *Business Week*, December 18, 1978, p. 86.

Exhibit I
One company's average cost of capital

	Weight	Cost	Weighted cost
Debt	.20	.05	.01
Equity	.80	.15	.12
Average cost of capital			.13

Exhibit II
Premerger financial statements for Alcar and Rano (in millions of dollars)

Statement of income (year ended December 31)

	Alcar	Rano
Sales	$600.00	$50.00
Operating expenses	522.00	42.50
EBIT	78.00	7.50
Interest on debt	4.50	.40
Earnings before taxes	73.50	7.10
Income taxes	36.00	3.55
Net income	$37.50	$3.55
Number of common shares outstanding (in millions)	10.00	1.11
Earnings per share	$3.75	$3.20
Dividends per share	1.30	.64

Statement of financial position (at year-end)

	Alcar	Rano
Net working capital	$180.00	$7.50
Temporary investments	25.00	1.00
Other assets	2.00	1.60
Fixed assets	216.00	20.00
Less accumulated depreciation	(95.00)	(8.00)
	$328.00	$22.10
Interest-bearing debt	$56.00	$5.10
Shareholders' equity	272.00	17.00
	$328.00	$22.10

situations. A better approach suggests that the forecast duration for cash flows should continue only as long as the expected rate of return on incremental investment required to support forecasted sales growth exceeds the cost-of-capital rate.

If for subsequent periods one assumes that the company's return on incremental investment equals the cost-of-capital rate, then the market would be indifferent whether management invests earnings in expansion projects or pays cash dividends that shareholders can in turn invest in identically riskv opportunities yielding an identical rate of retur. In other words, the value of the company is unaffected by growth when the company is investing in projects earning at the cost of capital or at the minimum acceptable risk-adjusted rate of return required by the market.

Thus, for purposes of simplification, we can assume a 100% payout of earnings after the horizon date or, equivalently, a zero growth rate without affecting the valuation of the company. (An implied assumption of this model is that the depreciation tax shield can be invested to maintain the company's productive capacity.) The residual value is then the present value of the resulting cash flow perpetuity beginning one year after the horizon date. Of course, if after the horizon date the return on investment is expected to decline below the cost-of-capital rate, this factor can be incorporated in the calculation.

When the acquisition candidate's risk is judged to be the same as the acquirer's overall risk, the appropriate rate for discounting the candidate's cash flow stream is the acquirer's cost of capital. The cost of capital or the minimum acceptable rate of return on new investments is based on the rate investors can expect to earn by investing in alternative, identically risky securities.

The cost of capital is calculated as the weighted average of the costs of debt and equity capital. For example, suppose a company's aftertax cost of debt is 5% and it estimates its cost of equity to be 15%. Further, it plans to raise future capital in the following proportions—20% by way of debt and 80% by equity. *Exhibit I* shows how to compute the company's average cost.

It is important to emphasize that the acquiring company's use of its own cost of capital to discount the target's projected cash flows is appropriate only when it can be safely assumed that the acquisition will not affect the riskiness of the acquirer. The specific riskiness of each prospective candidate should be taken into account in setting the discount rate, with higher rates used for more risky investments.

If a single discount rate is used for all acquisitions, then those with the highest risk will seem most attractive. Because the weighted average risk of its component segments determines the company's cost of capital, these high-risk acquisitions will increase a company's cost of capital and thereby decrease the value of its stock.

Case of Alcar Corporation

As an illustration of the recommended approach to acquisition analysis, consider the case of Alcar Corporation's interest in acquiring Rano Products. Alcar is a leading manufacturer and distributor in the industrial packaging and materials handling market. Sales in 1978 totaled $600 million. Alcar's acquisition strategy is geared toward buying companies with either similar marketing and distribution characteristics, similar production technologies, or a similar research and development orientation. Rano Products, a $50 million sales organization with an impressive new-product development record in industrial packaging, fits Alcar's general acquisition criteria particularly well. Premerger financial statements for Alcar and Rano are shown in *Exhibit II.*

Acquisition for cash

The interactive computer model for corporate planning and acquisition analysis used in the Alcar valuation to follow generates a comprehensive analysis for acquisitions financed by cash, stock, or any combination of cash, debt, preferred stock, and common stock. In this article, the analysis will concern only the cash and exchange-of-shares cases. In the cash acquisition case, the analysis follows six essential steps:

> Develop estimates needed to project Rano's cash flow contribution for various growth and profitability scenarios.

> Estimate the minimum acceptable rate of return for acquisition of Rano.

> Compute the maximum acceptable cash price to be paid for Rano under various scenarios and minimum acceptable rates of return.

> Compute the rate of return that Alcar will earn for a range of price offers and for various growth and profitability scenarios.

> Analyze the feasibility of a cash purchase in light of Alcar's current liquidity and target debt-to-equity ratio.

> Evaluate the impact of the acquisition on the earnings per share and capital structure of Alcar.

Step 1—cash flow projections: The cash flow formula presented earlier may be restated in equivalent form as—

Exhibit III
Most likely estimates for Rano's operations under Alcar control

	Years 1-5	6-7	8-10
Sales growth rate (*g*)	.15	.12	.12
EBIT as a percentage of sales (*p*)	.18	.15	.12
Income tax rate (*T*)	.46	.46	.46
Capital investment per dollar of sales increase (*f*)	.20	.20	.20
Working capital per dollar of sales increase (*w*)	.15	.15	.15

Employing the cash flow formula for year 1:

$CF_1 = 50(1+.15)(.18)(1-.46) - (57.5-50)(.20+.15) = 2.96$

$$CF_t = S_{t-1}(1+g_t)(p_t)(1-T_t) - (S_t - S_{t-1})(f_t + w_t)$$

where

CF = cash flow,
S = sales,
g = annual growth rate in sales,
p = EBIT as a percentage of sales,
T = income tax rate,
f = capital investment required (i.e., total capital investment net of replacement of existing capacity estimated by depreciation) per dollar of sales increase,
w = cash required for net working capital per dollar of sales increase.

Once estimates are provided for five variables, g, p, T, f, and w, it is possible to project cash flow.

Exhibit III shows Alcar management's "most likely" estimates for Rano's operations, assuming Alcar control; *Exhibit IV* shows a complete projected ten-year cash flow statement for Rano.

Before developing additional scenarios for Rano, I should make some brief comments on how to estimate some of the cash flow variables. The income tax rate is the effective cash rate rather than a rate based on the accountant's income tax expense, which often includes a portion that is deferred. For some companies, a direct projection of capital investment requirements per dollar of sales increase will prove a difficult task.

To gain an estimate of the recent value of this coefficient, simply take the sum of all capital investments less depreciation over the past five or ten years and divide this total by the sales increase from the beginning to the end of the period. With this approach, the resulting coefficient not only represents the capital investment historically required per dollar of sales increase but also impounds any cost increases for replacement of existing capacity.

One should estimate changes in net working capital requirements with care. Actual year-to-year balance sheet changes in net working capital may not provide a good measure of the rise or decline in funds required. There are two main reasons for this:

Exhibit IV
Projected ten-year cash flow statement for Rano (in millions of dollars)

	Years									
	1	2	3	4	5	6	7	8	9	10
Sales	$57.50	$66.12	$76.04	$87.45	$100.57	$112.64	$126.15	$141.29	$158.25	$177.23
Operating expenses	47.15	54.22	62.36	71.71	82.47	95.74	107.23	124.34	139.26	155.97
EBIT	$10.35	$11.90	$13.69	$15.74	$18.10	$16.90	$18.92	$16.95	$18.99	$21.27
Income taxes on EBIT	4.76	5.48	6.30	7.24	8.33	7.77	8.70	7.80	8.74	9.78
Operating earnings after taxes	$5.59	$6.43	$7.39	$8.50	$9.78	$9.12	$10.22	$9.16	$10.25	$11.48
Depreciation	1.60	1.85	2.13	2.46	2.84	3.28	3.74	4.25	4.83	5.49
Less capital expenditures	(3.10)	(3.57)	(4.12)	(4.74)	(5.47)	(5.69)	(6.44)	(7.28)	(8.22)	(9.29)
Less increase in working capital	(1.13)	(1.29)	(1.49)	(1.71)	(1.97)	(1.81)	(2.03)	(2.27)	(2.54)	(2.85)
Cash flow	$2.96	$3.41	$3.92	$4.51	$5.18	$4.90	$5.49	$3.86	$4.32	$4.84

(1) the year-end balance sheet figures may not reflect the average or normal needs of the business during the year, and (2) both the accounts receivable and inventory accounts may overstate the magnitude of the funds committed by the company.

To estimate the additional cash requirements, the increased inventory investment should be measured by the variable costs for any additional units of inventory required and by the receivable investment in terms of the variable costs of the product delivered to generate the receivable rather than the absolute dollar amount of the receivable.[4]

In addition to its most likely estimate for Rano, Alcar's management developed two additional (conservative and optimistic) scenarios for sales growth and EBIT-sales ratio. *Exhibit V* gives a summary of all three scenarios. Alcar's management may also wish to examine additional cases to test the effect of alternative assumptions about the income tax rate and capital investment and working capital requirements per dollar of sales increase.

Recall that cash flows should be forecast only for the period when the expected rate of return on incremental investment exceeds the minimum acceptable rate of return for the acquisition. It is possible to determine this in a simple yet analytical, nonarbitrary, fashion. To do so, we compute the minimum pretax return on sales (P min) needed to earn the minimum acceptable rate of return on the acquisition (k) given the investment requirements for working capital (w) and fixed assets (f) for each additional dollar of sales and given a projected tax rate (T). The formula for P min is:

$$P_{min} = \frac{(f+w)\,k}{(1-T)\,(1+k)}.$$

Alcar's management believes that when Rano's growth begins to slow down, its working capital requirements per dollar of additional sales will increase from .15 to about .20 and its effective tax rate will increase from .46 to .50. As will be shown in the next section, the minimum acceptable rate of return on the Rano acquisition is 13%. Thus:

$$P_{min} = \frac{(.20+.20)\,(.13)}{(1-.50)\,(1+.13)} = .092.$$

Alcar's management has enough confidence to forecast pretax sales returns above 9.2% for only the next ten years, and thus the forecast duration for the Rano acquisition is limited to that period.

Step 2—estimate minimum acceptable rate of return for acquisition: In developing a company's average cost of capital, measuring the aftertax cost of debt is relatively straightforward. The cost of equity capital, however, is more difficult to estimate.

Rational, risk-averse investors expect to earn a rate of return that will compensate them for accepting greater investment risk. Thus, in assessing the company's cost of equity capital or the minimum expected return that will induce investors to buy the company's shares, it is reasonable to assume that they will demand the risk-free rate as reflected in the current yields available in government bonds, plus a premium for accepting equity risk.

4. For an illustration of this calculation, see my article, "Measuring Company Growth Capacity During Inflation," HBR January-February 1979, p. 91.

5. For example, see Roger G. Ibbotson and Rex A. Sinquefield, *Stock, Bonds, Bills, and Inflation: The Past (1926-1976) and the Future (1977-2000)* (New York: Financial Analysts Research Foundation, 1977), p. 57. They forecast that returns on common stocks will exceed those on long-term government bonds by 5.4%.

6. For a discussion of some of the problems in estimating beta as a measure of risk, see Eugene F. Brigham, *Financial Management: Theory and Practice* (Hinsdale, Ill.: The Dryden Press, 1977), p. 666.

Recently, the risk-free rate on government bonds ıas been in the neighborhood of 8.8%. By investing in a portfolio broadly representative of the overall equity market, it is possible to diversify away substantially all of the unsystematic risk—that is, risk specific to individual companies. Therefore, securities are likely to be priced at levels that reward investors only for the nondiversifiable market risk—that is, the systematic risk in movements in the overall market.

The risk premium for the overall market is the excess of the expected return on a representative market index such as the Standard & Poor's 500 stock index over the risk-free return. Empirical studies have estimated this market risk premium (representative market index minus risk-free rate) to average historically about 5% to 5.5%.[5] I will use a 5.2% premium in subsequent calculations.

Investing in an individual security generally involves more or less risk than investing in a broad market portfolio, thus one must adjust the market risk premium appropriately in estimating the cost of equity for an individual security. The risk premium for a security is the product of the market risk premium times the individual security's systematic risk, as measured by its beta coefficient.

The rate of return from dividends and capital appreciation on a market portfolio will, by definition, fluctuate identically with the market, and therefore its beta is equal to 1.0. A beta for an individual security is an index of its risk expressed as its volatility of return in relation to that of a market portfolio.[6] Securities with betas greater than 1.0 are more volatile than the market and thus would be expected to have a risk premium greater than the overall market risk premium or the average-risk stock with a beta of 1.0.

For example, if a stock moves 1.5% when the market moves 1%, the stock would have a beta of 1.5. Securities with betas less than 1.0 are less volatile than the market and would thus command risk premiums less than the market risk premium. In summary, the cost of equity capital may be calculated by the following equation:

$$k_E = R_F + B_j\,(R_M - R_F)$$

where

k_E = cost of equity capital,
R_F = risk-free rate,
B_j = the beta coefficient,
R_M = representative market index.

The acquiring company, Alcar, with a beta of 1.0, estimated its cost of equity as 14% with the foregoing equation:

$$k_E = .088 + 1.0(.052) = \underline{\underline{.140}}$$

Exhibit V
Additional scenarios for sales growth and EBIT/sales

	Sales growth			EBIT/sales		
	Years			Years		
Scenario	1-5	6-7	8-10	1-5	6-7	8-10
1. Conservative	.14	.12	.10	.17	.14	.11
2. Most likely	.15	.12	.12	.18	.15	.12
3. Optimistic	.18	.15	.12	.20	.16	.12

Exhibit VI
Alcar's weighted average cost of capital

	Weight	Cost	Weighted Cost
Debt	.23	.051	.012
Equity	.77	.140	.108
Average cost of capital			.120

Exhibit VII
Risk-adjusted cost of capital for Rano acquisition

	Weight	Cost	Weighted cost
Debt	.23	.054*	.012
Equity	.77	.153	.118
Average risk-adjusted cost of capital			.130

*Before-tax debt rate of 10% times 1 minus the estimated tax rate of 46%.

Since interest on debt is tax deductible, the rate of return that must be earned on the debt portion of the company's capital structure to maintain the earnings available to common shareholders is the aftertax cost of debt. The aftertax cost of borrowed capital is Alcar's current beforetax interest rate (9.5%) times 1 minus its effective tax rate of 46%, which is equal to 5.1%. Alcar's target debt-to-equity ratio is .30, or, equivalently, debt is targeted at 23% and equity at 77% of its overall capitalization as *Exhibit VI* shows Alcar's weighted average cost of capital. The appropriate rate for discounting Alcar cash flows to establish its estimated value is then 12%.

For new capital projects, including acquisitions, that are deemed to have about the same risk as the overall company, Alcar can use its 12% cost-of-capital rate as the appropriate discount rate. Because the company's cost of capital is determined by the weighted average risk of its component segments, the specific risk of each prospective acquisition should be estimated in order to arrive at the discount rate to apply to the candidate's cash flows.

Exhibit VIII
Maximum acceptable cash price for Rano—most likely scenario, with a discount rate of .130 (in millions of dollars)

Year	Cash flow	Present value	Cumulative present value
1	$ 2.96	$ 2.62	$ 2.62
2	3.41	2.67	5.29
3	3.92	2.72	8.01
4	4.51	2.76	10.77
5	5.13	2.81	13.59
6	4.90	2.35	15.94
7	5.49	2.33	18.27
8	3.86	1.45	19.72
9	4.32	1.44	21.16
10	4.84	1.43	22.59
Residual value	11.48	26.02*	48.61
Plus temporary investments not required for current operations			1.00
Less debt assumed			5.10
Maximum acceptable cash price			$44.51
Maximum acceptable cash price per share			$40.10

$$*\frac{\text{Year 10 operating earnings after taxes}}{\text{Discount rate}} \times \text{Year 10 discount factor} =$$

$$\frac{11.48}{.13} \times .2946 = 26.02$$

Rano, with a beta coefficient of 1.25, is more risky than Alcar, with a beta of 1.0. Employing the formula for cost of equity capital for Rano:

$$k_E = .088 + 1.25(.052)$$
$$= .153$$

On this basis, the risk-adjusted cost of capital for the Rano acquisition is as shown in *Exhibit VII.*

Step 3—compute maximum acceptable cash price: This step involves taking the cash flow projections developed in Step 1 and discounting them at the rate developed in Step 2. *Exhibit VIII* shows the computation of the maximum acceptable cash price for the most likely scenario. The maximum price of $44.51 million, or $40.10 per share, for Rano compares with a $25 current market price for Rano shares. Thus, for the most likely case, Alcar can pay up to $15 per share, or a 60% premium over current market, and still achieve its minimum acceptable 13% return on the acquisition.

Exhibit IX shows the maximum acceptable cash price for each of the three scenarios for a range of discount rates. To earn a 13% rate of return, Alcar can pay at maximum $38 million ($34.25 per share), assuming the conservative scenario, and up to $53 million ($47.80 per share), assuming the optimistic scenario. Note that as Alcar demands a greater return on its investment, the maximum price it can pay decreases. The reverse is, of course, true as well. For example, for the most likely scenario, the maximum price decreases from $44.51 million to $39.67 million as the return requirement goes from 13% to 14%.

Step 4—compute rate of return for various offering prices and scenarios: Alcar management believes that the absolute minimum successful bid for Rano would be $35 million, or $31.50 per share. Alcar's investment bankers estimated that it may take a bid of as high as $45 million, or $40.50 per share, to gain control of Rano shares. *Exhibit X* presents the rates of return that will be earned for four different offering prices, ranging from $35 million to $45 million for each of the three scenarios.

Under the optimistic scenario, Alcar could expect a return of 14.4% if it were to pay $45 million. For the most likely case, an offer of $45 million would yield a 12.9% return, or just under the minimum acceptable rate of 13%. This is as expected, since the maximum acceptable cash price as calculated in *Exhibit VIII* is $44.51 million, or just under the $45 million offer. If Alcar attaches a relatively high probability to the conservative scenario, the risk associated with offers exceeding $38 million becomes apparent.

Step 5—analyze feasibility of cash purchase: While Alcar management views the relevant purchase price range for Rano as somewhere between $35 and $45 million, it must also establish whether an all-cash deal is feasible in light of Alcar's current liquidity and target debt-to-equity ratio. The maximum funds available for the purchase of Rano equal the postmerger debt capacity of the combined company less the combined premerger debt of the two companies plus the combined premerger temporary investments of the two companies. (Net working capital not required for everyday operations of the business is classified as "temporary investment.")

In an all-cash transaction governed by purchase accounting, the acquirer's shareholders' equity is unchanged. The postmerger debt capacity is then Alcar's shareholders' equity of $272 million times the targeted debt-to-equity ratio of .30, or $81.6 million. Alcar and Rano have premerger debt balances of $56 million and $5.1 million, respectively, for a total of $61.1 million.

The unused debt capacity is thus $81.6 million minus $61.1 million, or $20.5 million. Add to this the combined temporary investments of Alcar and Rano of $26 million, and the maximum funds avail-

Exhibit IX
Maximum acceptable cash price for three scenarios and a range of discount rates

	Discount rates				
Scenarios	.11	.12	.13	.14	.15
1. Conservative					
Total price ($ millions)	$48.84	$42.91	$38.02	$33.93	$30.47
Per share price	44.00	38.66	34.25	30.57	27.45
2. Most likely					
Total price ($ millions)	57.35	50.31	44.51	39.67	35.58
Per share price	51.67	45.33	40.10	35.74	32.05
3. Optimistic					
Total price ($ millions)	68.37	59.97	53.05	47.28	42.41
Per share price	61.59	54.03	47.80	42.59	38.21

able for the cash purchase of Rano will be $46.5 million. A cash purchase is therefore feasible within the tentative price range of $35 to $45 million.

Step 6–evaluate impact of acquisition on Alcar's EPS and capital structure: Because reported earnings per share (EPS) continue to be of great interest to the financial community, a complete acquisition analysis should include a comparison of projected EPS both with and without the acquisition. *Exhibit XI* contains this comparative projection. The EPS stream with the acquisition of Rano is systematically greater than the stream without acquisition. The EPS standard, and particularly a short-term EPS standard, is not, however, a reliable basis for assessing whether the acquisition will in fact create value for shareholders.[7]

Several problems arise when EPS is used as a standard for evaluating acquisitions. First, because of accounting measurement problems, the EPS figure can be determined by alternative, equally acceptable methods–for example, LIFO versus FIFO. Second, the EPS standard ignores the time value of money. Third, it does not take into account the risk of the EPS stream. Risk is conditioned not only by the nature of the investment projects a company undertakes but also by the relative proportions of debt and equity used to finance those investments.

A company can increase EPS by increasing leverage as long as the marginal return on investment is greater than the interest rate on the new debt. However, if the marginal return on investment is less than the risk-adjusted cost of capital or if the increased leverage leads to an increased cost of capital, then the value of the company could decline despite rising EPS.

Primarily because the acquisition of Rano requires that Alcar partially finance the purchase

Exhibit X
Rate of return for various offering prices and scenarios

	Offering price				
	Total ($ millions)	$35.00	$38.00	$40.00	$45.00
Scenarios	Per share	$31.53	$34.23	$36.04	$40.54
1. Conservative		.137	.130	.126	.116
2. Most likely		.152	.144	.139	.129
3. Optimistic		.169	.161	.156	.144

Exhibit XI
Alcar's projected EPS, debt-to-equity ratio, and unused debt capacity–without and with Rano acquisition

	EPS		Debt/equity		Unused debt capacity (in millions of dollars)	
Year	Without	With	Without	With	Without	With
0	$ 3.75	$ 4.10	.21	.26	$25.60	$20.50
1	4.53	4.89	.19	.27	34.44	9.42
2	5.09	5.51	.17	.28	44.22	7.00
3	5.71	6.20	.19	.29	40.26	4.20
4	6.38	6.99	.21	.30	35.45	.98
5	7.14	7.87	.24	.31	29.67	−2.71
6	7.62	8.29	.26	.31	22.69	−7.77
7	8.49	9.27	.27	.32	14.49	−13.64
8	9.46	10.14	.29	.33	4.91	−22.34
9	10.55	11.33	.31	.34	−6.23	−32.36
10	11.76	12.66	.32	.35	−19.16	−43.88

Note: Assumed cash purchase price for Rano is $35 million.

7. See William W. Alberts and James M. McTaggart, "The Short-Term Earnings Per Share Standard for Evaluating Prospective Acquisitions," *Mergers and Acquisitions*, Winter 1978, p. 4; and Joel M. Stern, "Earnings Per Share Don't Count," *Financial Analysts Journal*, July-August 1974, p. 39.

Exhibit XII
Most likely estimates for Alcar operations without acquisition

	Years 1-5	6-7	8-10
Sales growth rate	.125	.120	.120
EBIT as a percentage of sales	.130	.125	.125
Income tax rate	.460	.460	.460
Capital investment per dollar of sales increase	.250	.250	.250
Working capital per dollar of sales increase	.300	.300	.300

Exhibit XIII
Estimated present value of Alcar equity–most likely scenario, with a discount rate of .120 (in millions of dollars)

Year	Cash flow	Present value	Cumulative present value
1	$ 6.13	$ 5.48	$ 5.48
2	6.90	5.50	10.98
3	7.76	5.53	16.51
4	8.74	5.55	22.06
5	9.83	5.58	27.63
6	10.38	5.26	32.89
7	11.63	5.26	38.15
8	13.02	5.26	43.41
9	14.58	5.26	48.67
10	16.33	5.26	53.93
Residual value	128.62	345.10*	399.03
Plus temporary investments not required for current operations			25.00
Less debt outstanding			56.00
Present value of Alcar equity			$368.03
Present value per share of Alcar equity			$ 36.80

*Year 10 operating earnings after taxes / Discount rate × Year 10 discount factor =

$\frac{128.62}{.12} \times .32197 = 345.10$

price with bank borrowing, the debt-to-equity ratios with the acquisition are greater than those without the acquisition (see *Exhibit XI*). Note that even without the Rano acquisition, Alcar is in danger of violating its target debt-to-equity ratio of .30 by the ninth year. The acquisition of Rano accelerates the problem to the fifth year. Whether Alcar purchases Rano or not, management must now be alert to the financing problem, which may force it to issue additional shares or reevaluate its present capital structure policy.

Acquisition for stock

The first two steps in the acquisition-for-stock analysis, projecting Rano cash flows and setting the discount rate, have already been completed in connection with the acquisition-for-cash analysis developed in the previous section. The remaining steps of the acquisition-for-stock analysis are:

> Estimate the value of Alcar shares.

> Compute the maximum number of shares that Alcar can exchange to acquire Rano under various scenarios and minimum acceptable rates of return.

> Evaluate the impact of the acquisition on the earnings per share and capital structure of Alcar.

Step 1–estimate value of Alcar shares: Alcar conducted a comprehensive corporate self-evaluation that included an assessment of its estimated present value based on a range of scenarios. In the interest of brevity, I will consider here only its most likely scenario.

Management made most likely projections for its operations, as shown in *Exhibit XII*. Again using the equation for the cost of equity capital, the minimum EBIT as a percentage of sales needed to earn at Alcar's 12% cost of capital is 10.9%. Since management can confidently forecast pretax return on sales returns above 10.9% for only the next ten years, the cash flow projections will be limited to that period.

Exhibit XIII presents the computation of the value of Alcar's equity. Its estimated value of $36.80 per share contrasts with its currently depressed market value of $22 per share. Because Alcar management believes its shares to be substantially undervalued by the market, in the absence of other compelling factors it will be reluctant to acquire Rano by means of an exchange of shares.

To illustrate, suppose that Alcar were to offer $35 million in cash for Rano. Assume the most likely case, that the maximum acceptable cash price is $44.51 million (see *Exhibit VIII*); thus the acquisition would create about $9.5 million in value for Alcar shareholders. Now assume that instead Alcar agrees to exchange $35 million in market value of its shares in order to acquire Rano. In contrast with the cash case, in the exchange-of-shares case Alcar shareholders can expect to be worse off by $12.1 million.

With Alcar shares selling at $22, the company must exchange 1.59 million shares to meet the $35

million offer for Rano. There are currently 10 million Alcar shares outstanding. After the merger, the combined company will be owned 86.27%—i.e., (10.00)/(10.00 + 1.59)—by current Alcar shareholders and 13.73% by Rano shareholders. The $12.1 million loss by Alcar shareholders can then be calculated as shown in *Exhibit XIV*.

Step 2—compute maximum number of shares Alcar can exchange: The maximum acceptable number of shares to exchange for each of the three scenarios and for a range of discount rates appears in *Exhibit XV*. To earn a 13% rate of return, Alcar can exchange no more than 1.033, 1.210, and 1.442 million shares, assuming the conservative, most likely, and optimistic scenarios, respectively. Consider, for a moment, the most likely case. At a market value per share of $22, the 1.21 million Alcar shares exchanged would have a total value of $26.62 million, which is less than Rano's current market value of $27.75 million—that is, 1.11 million shares at $25 per share. Because of the market's apparent undervaluation of Alcar's shares, an exchange ratio likely to be acceptable to Rano will clearly be unattractive to Alcar.

Step 3—evaluate impact of acquisition on Alcar's EPS and capital structure: The $35 million purchase price is just under ten times Rano's most recent year's earnings of $3.55 million. At its current market price per share of $22, Alcar is selling at about six times its most recent earnings. The acquiring company will always suffer immediate EPS dilution whenever the price-earnings ratio paid for the selling company is greater than its own. Alcar would suffer immediate dilution from $3.75 to $3.54 in the current year. A comparison of EPS for cash versus an exchange-of-shares transaction appears as part of *Exhibit XVI*. As expected, the EPS projections for a cash deal are consistently higher than those for an exchange of shares.

However, the acquisition of Rano for shares rather than cash would remove, at least for now, Alcar's projected financing problem. In contrast with a cash acquisition, an exchange of shares enables Alcar to have unused debt capacity at its disposal throughout the ten-year forecast period. Despite the relative attractiveness of this financing flexibility, Alcar management recognized that it could not expect a reasonable rate of return by offering an exchange of shares to Rano.

Exhibit XIV
Calculation of loss by Alcar shareholders (in millions of dollars)

Alcar receives 86.27% of Rano's present value of $44.51 million (see *Exhibit VIII*)	$38.4
Alcar gives up 13.73% of its present value of $368.03 million (see *Exhibit XIII*)	(50.5)
Dilution of Alcar shareholders' value	$12.1

Exhibit XV
Maximum acceptable shares to exchange for three scenarios and a range of discount rates (in millions)

	Discount rates				
Scenarios	.11	.12	.13	.14	.15
1. Conservative	1.327	1.166	1.033	0.922	0.828
2. Most likely	1.558	1.367	1.210	1.078	0.967
3. Optimistic	1.858	1.630	1.442	1.285	1.152

Exhibit XVI
Alcar's projected EPS, debt-to-equity ratio, and unused debt capacity—cash vs. exchange of shares

	EPS		Debt/equity		Unused debt capacity (in millions of dollars)	
Year	Cash	Stock	Cash	Stock	Cash	Stock
0	$ 4.10	$ 3.54	.26	.21	$20.50	$25.60
1	4.89	4.37	.27	.19	9.42	35.46
2	5.51	4.93	.28	.17	7.00	46.62
3	6.20	5.55	.29	.18	4.20	48.04
4	6.99	6.23	.30	.20	0.98	46.37
5	7.87	7.00	.31	.21	−2.71	44.29
6	8.29	7.37	.31	.23	−7.77	40.90
7	9.27	8.22	.32	.24	−13.64	36.78
8	10.14	8.98	.33	.26	−22.34	29.90
9	11.33	10.01	.34	.27	−32.66	21.79
10	12.66	11.17	.35	.29	−43.88	12.29

Note: Assumed purchase price for Rano is $35 million.

Concluding note

The experience of companies that have implemented the approach to acquisition analysis described in this article indicates that it is not only an effective way of evaluating a prospective acquisition candidate but also serves as a catalyst for reevaluating a company's overall strategic plans. The results also

enable management to justify acquisition recommendations to the board of directors in an economically sound, convincing fashion.

Various companies have used this approach for evaluation of serious candidates as well as for initial screening of potential candidates. In the latter case, initial input estimates are quickly generated to establish whether the range of maximum acceptable prices is greater than the current market price of the target companies. With the aid of a computer model, this can be accomplished quickly and at relatively low cost.

Whether companies are seeking acquisitions or are acquisition targets, it is increasingly clear that they must provide better information to enable top management and boards to make well-conceived, timely decisions. Use of the approach outlined here should improve the prospects of creating value for shareholders by acquisitions.

Competitive edge

The competitive significance of leading-edge strategic planning is underscored by something that the chief executive of one of America's most successful companies said recently. In responding to a question asking him to identify the reasons for his company's outstanding and long-sustained leadership position in its industry, he said: "In the main, our competitors are acquainted with the same fundamental concepts and techniques and approaches that we follow, and they are as free to pursue them as we are. More often than not, the difference between their level of success and ours lies in the relative thoroughness and self-discipline with which we and they develop and execute our strategies for the future."

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Due Diligence

Mapping a Battle Strategy To Check Out a Risky Target

Part I: Assembling a Team, Pinpointing the Issues

2

WHARTON REPROGRAPHICS

Howard S. Lanznar, Stephen M. Neumer, Paul Mayfield, and Tim Williamson

Modern acquisition due diligence goes far beyond straightforward bean counting and tire kicking. The savvy buyer must burrow into a wide range of risk management and qualitative characteristics of the target that are difficult to identify, much less investigate, and unearth facts. In this mock dramatization, four veteran due diligence professionals plot investigatory strategy at a crucial dealmaking point — when the buyer needs the right information to offer an economically sound yet competitive price. They not only pinpoint the primary issues and determine ways of checking them out but also discuss the real-world trade-offs and ramifications of each step to their client as a bidder, buyer, and eventual operator of the target.

In addition, the dramatization deals with the added pressures of an increasingly frequent acquisition opportunity in the early 1990s — the purchase of assets from a troubled or highly leveraged owner.

Part One of this article covers the cost-efficient organization of the due diligence team, identification of issues, and exploration of the target's financials. The article is based on a presentation to the Midwest Conference on Mergers and Acquisitions in October 1990 in Chicago.

The Cast of Characters

Stephen Nowall: CEO of Ace. Played by Stephen Neumer of Katten Muchin & Zavis.

Howard Lawless: Partner in the law firm of Willit, Grillit & Billit. Played by Howard Lanznar of Katten Muchin & Zavis.

Paul Maybee: Senior Partner in the accounting firm of Price, Ernst, Deloitte & Marwick. Played by Paul Mayfield of Ernst & Young.

Tim Megabucks: Managing Director of the investment banking firm of Churnim, Burnham & Fee. Played by Tim Williamson of Ernst & Young.

Organizing the Investigation Team, Focusing on the Critical Issues

Stephen Nowall: I am very eager to buy Target Tank Tread because it has tremendous cash flow, and with our relationships to Washington and Springfield (Illinois), we could probably increase our government contracts. I need to know more about the company to determine whether I should go to the second round of bidding, and I don't want to spend a heck of a lot of money doing a full due diligence. But, I don't want to lose this deal, either.

So, I want to talk first about how we should go

Howard S. Lanznar and Stephen M. Neumer are Partners in the Chicago law firm of Katten Muchin & Zavis. Paul Mayfield and Tim Williamson are Partners in the Chicago office of Ernst & Young.

about the due diligence process. I don't necessarily want to know exactly what items to look for but, rather, who should run it, how much money we should spend, and how we should approach this process.

Howard Lawless: You are really asking how we can do this job efficiently. One approach is to have all of our SWAT teams swarm on Tank Tread's data room, look at every piece of paper, and send people out to kick all the tires. We will get a lot of information very quickly, but that approach is costly.

Eventually we may have to do that, but for now, we have to see how much leeway you have and how many other bidders are involved. We should anticipate that there are a lot of bidders for this company.

At this point, I would suggest that we divide what we do into phases and start by looking at the critical issues. Most due diligence isn't going to unearth buried treasure, nor is it going to uncover time bombs. Let's concentrate on those aspects that you can find very important.

Nowall: Are you suggesting that we go through your entire 40-page checklist of everything that I should look at before I close the deal?

Lawless: Before you send the money to Global Worldwide, we probably will have checked just about every item on that list. But, to save you money and to do this efficiently, we should focus on just the three or four critical areas that we really need to get a handle on to determine whether you even want to proceed with your bid and how much you want to bid.

Nowall: What if the other bidders get ahead of us because they decide to spend more money? Am I behind in the bidding process? Am I likely not to get to the final bargaining table?

Lawless: Our experience lately is that deals take much longer to complete. Even if your competitor has done a lot of detailed work, it is going to have several more months of additional due diligence to do. And its financing sources will want to do very extensive due diligence. I don't think that you will be out of the running.

Tim Megabucks: Given this market and given what we know of the market intelligence about who is in the deal, I suspect that the other bidders won't spend all that money before they are certain they have a deal.

The Scenario

Ace Acquisition Co., a conservatively run, family-owned, and leverage-free Midwest manufacturer of industrial products, is bidding on Target Tank Tread, a New Jersey-based producer of treads and propulsion systems for military and recreational vehicles. Although a highly successful business, Target is a division of Global Worldwide Industries Inc. which is reeling under the massive debt load incurred when it went private in a leveraged buyout two years before. Global must sell assets to survive, and has put Target Tank Tread on the block.

Ace has qualified for the second round of bidding, and badly wants Target but is wrestling with the wrenching changes in its traditional world that will result from the deal. While an experienced acquirer, Ace never has bought anything as big as Target, and for the first time in its history, it is taking on a heavy debt load to swing the deal.

The Problem

Ace needs a plethora of solid, additional information from the due diligence process to determine (1) whether it will bid at all in the second round, and (2) what price it will offer if it continues in the running. But it wants to keep the investigatory costs down, because it may not be the successful bidder.

Nowall: So, Paul, what are some of the things that I ought to look at now, before I make my next bid?

Paul Maybee: From a financial point of view, we have to get all of the deal breakers on the table and get some satisfaction that none of those pertains to this acquisition. We also have to understand what assumptions are key to your financing proposal and get some comfort that the numbers are really working out the way we think that they are.

One of the biggest stumbling blocks that I have with this company is that it has never been audited, and we really don't know how good even the beginning numbers are. On top of that, the investment bankers have put together a pro forma adjustment schedule that massages the historical numbers and recasts them to eliminate certain

transactions and events that they consider to be unusual. We need to spend a lot of time to understand those transactions.

Nowall: Then, you don't feel comfortable just making the seller represent and warrant those financials?

Maybee: Not at this point.

Nowall: That does affect the price I am going to put on the table. So, I really need to have comfort in the numbers.

Maybee: Your risk is that if you accept pro forma adjustments that may be invalid, your bid will be too high and you won't have satisfactory outs on the back end.

Beyond the Financials: Ferreting Out the Hidden Costs

Nowall: Besides a reasonable level of comfort from the numbers before I bid, what else should I look at?

Lawless: On the legal side, we also want to look at those areas that can be real deal breakers. But let me clarify something about the contract and the representations and warranties.

If Global Worldwide was a solid company that had a great balance sheet that can stand behind the reps and warranties, maybe we could rely on them. But let's remember where Global Worldwide is. They are wheezing. They are under tremendous financial pressures. We cannot assume that they will be around in a year or two when we might discover a violation in a rep or a warranty. So we have to do more homework now.

We will try very hard to spread some of the risk to them. But we can't assume that they will be there in the future and we can't just lie back and rely on our contract.

Megabucks: Given the fact that you are really betting the ranch and doubling the size of your company, you want to be very certain that this is a good acquisition. As a defense contractor, Tank Tread may have extensive liabilities related to that business. So you don't want to be penny-wise and pound-foolish at this stage.

You have to do enough due diligence to eliminate the deal breakers from the value adjustments. If you gain comfort on the deal breakers, the value adjustments can be put into your purchase price. So, we should focus on making sure that we get the right information at this stage.

Lawless: We need to look at employee benefit provisions, such as retiree medical and health plans and pension benefits, particularly multi-employer plans in these areas. Also, Tank Tread is substantially unionized, and most of your operations aren't unionized, so you are entering a different world. We must get comfortable with the collective bargaining agreements and all of the other health and welfare issues.

We need to look at insurance. As a maker of tanks and off-road vehicles, the company is prone to product liability claims, and there are probably environmental claims as well. You want to make sure that there is a maximum of insurance there to minimize the management risk.

Nowall: How about some of the key contracts with the U.S. government? Do you think it would be important to look at them now, or should we do that later?

Lawless: We are going to examine the key M-1 tank contract that I found in the data room. It is 600 pages long, but we have to study at least some major portions of it. We must find out, for example, whether we need to have the Department of Defense qualify you as a government contractor if you wind up buying Tank Tread.

Nowall: How can we go about this to cut costs? Who should run it? Should some of my people do it? What should we make the seller do? Since I may not be the winning bidder, I don't want to spend too much money during this second round.

Lawless: It is a good idea to use your people. I or someone from my firm will be in the data room with them, but we can coach your financial and accounting people in how to review some of the extensive documentation, tell them what to look for, and have them summarize it, so you can save costs. Your people are certainly less expensive than even the young attorneys from my firm.

We should have Global assume more of the labor. I was in their data room yesterday and there are boxes and boxes piled on tables. Global's people should organize the information.

Megabucks: Another useful tactic is to organize our questions so that there is efficiency in sending them to Global. We can ask Global to specifically answer

all of our questions before we collectively go into the data room, meet their management, and meet their accountants. That is an organized approach to the due diligence process.

Lawless: The seller should put schedules together for us before we go into those meetings. They didn't take the trouble to attach schedules to their draft agreement, so we have no idea what they are going to look like and whether everything we want is in the data room.

Megabucks: That is important. In too many instances, due diligence is done two, or even three, times. There is an entire due diligence when you are putting the bid together and looking through the data room. When you start putting the contract schedules together, a different group does the same due diligence all over again.

The third time is when the bank and financing sources finally come in and do yet another round of due diligence. There is no reason why it has to be done three times. It should be done just once.

Maybee: We have to remember that the seller's time is worth money, too, and the simpler that we can make the process for them, with the least amount of duplication, the more amenable they are going to be.

Bringing the Banks Into the Due Diligence Loop

Nowall: When do we bring our lenders in? I don't want to go through this twice and then have the lenders do it again. Maybe we should get them in sooner rather than later?

Megabucks: We can take a bifurcated approach. Lenders like to be in as soon as possible, so I would suggest that you have your banking institution in to the extent that we can determine any mezzanine sources that you might need. Have them in right at the beginning and let them get a feel for the transaction.

They are not going to want to go through the data room to the extent that we are. But if we get them in early, get them comfortable, and get them to start looking at the numbers that we have put together, it is really going to ease the process.

Maybee: It is worth explaining to the seller, though, that the lenders — if they are asset-based institutions — will have collateral auditors who will ask a lot of detailed questions that will be somewhat different from the ground that we covered.

Megabucks: That should probably be in phase two of the process. We are not going to bring in collateral auditors until we are pretty sure that we have the deal.

Nowall: Tim, who should coordinate that? Should it be my lawyer, my investment banker, my accountant? Does it make a difference who coordinates the first round?

Megabucks: We should have a collective approach. We can put together an organized schedule and confirm it with the seller. But, Steve, you really must lead the process and push it forward because you are buying the company. We can be supportive in the organizational process.

Lawless: This has to be a coordinated effort because, in my experience, the things you discover in due diligence aren't always neatly categorized. You may have someone doing a legal review who comes up with a financial issue. Or an operational person can come up with a legal document that a lawyer should look at. So, you have to run the process because you are going to decide whether to buy the company. We have to coordinate and get the due diligence teams to meet frequently so that we don't miss things that are really in front of us.

Why the Reported Financial Results Are Just a Jumping-Off Point

Nowall: Let's talk about the financial issues. We have a set of unaudited financials, and my guess is that they have been moving money back and forth between the sub and the parent because Global needs cash. There have been a lot of intercompany transactions.

I am very uncomfortable with the way that Global's investment banker put those financials together and I don't think I can rely on them.

Maybee: Not only are they unaudited but Tank Tread was never a big enough part of Global to come under segment disclosure requirements when Global was a public company. So, the public accountants have never presented any statements, even in abbreviated note form. That doesn't mean, though, that they haven't done a lot of work on Target.

Target has some fairly high-risk businesses, and it is entirely possible that the auditors sent teams to the Target locations and performed many tests there. It is also possible that Global's internal auditors spent some time on the financial statements.

Our first step is to get access to the work papers of the external accountants and, to the extent relevant, the internal accountants, and figure out what procedures were followed and what the findings were. We should plan our procedures from that point.

Megabucks: Steve, now that your company is getting pretty big, you may need some equity capital from a public offering in the next year or two. That means we will need audited figures going back three years, and if an audit is unachievable with this acquisition, it may limit your planning and your flexibility. In effect, you may have to own Target for three years before you can go public. So, we have to determine whether we can perform an audit on Target into three years of historical figures.

Nowall: Should we do the audit before we make the next bid; before closing; or after the deal, with provisions for a post-closing adjustment?

Megabucks: We certainly will demand a closing audit. But at this stage of the transaction, it is enough to just determine whether an audit is achievable for the last three years and whether all the work papers and necessary material are available.

Lawless: In addition to the balance sheet, we want them to deliver the audited, historical financial statements before closing. The last thing that you want is to try to track down the records that Global Worldwide might have now but might not keep after it has sold Target. You want to get that all buttoned up while Global still has an incentive to provide those financial statements.

Nowall: If those work papers are insufficient, should we ask the seller to give us an audit for all three years before we close? Do you think we can get that?

Megabucks: I think that is unlikely. It represents a substantial cost. It is probably something that you will have to pay for.

Maybee: We must acknowledge, though, that the lenders may want some kind of audit before they finalize their commitment.

Lawless: That's another reason to get the lenders involved early. They will want some comfort in the numbers.

Maybee: They may go as far as wanting an audit, probably after your bid but before closing.

Nowall: Would that be at my cost or Global's?

Megabucks: I would suspect it would be at your cost. We are going to do a lot of due diligence and find a lot of items that affect value, both positively and negatively.

The Ripple Effects Of the Financial Probing

Nowall: What kinds of things do you think you will find when you start looking at their interim financial statements and their unaudited statements?

Maybee: If they didn't have an inventory problem, I would be surprised. I haven't seen a company yet that hasn't had one. But before we go to that phase, there are other important things to do in phase one.

In addition to the historical financial statements that Global's investment bankers have included in the deal book, there is a schedule called "Pro Forma Adjustments." The purpose is to take the historical earnings, which seem to have gyrated considerably between some good years and some very bad years, and to remove transactions that were considered nonrecurring. That recast the earnings on what would be a normalized, going-forward basis. They are inviting you to formulate your bid on these earnings. We really have to get an understanding of the types of transactions that have been included.

I noticed that almost all of the pro forma adjustments involved the reversing of expenses, which means that almost every adjustment increased income. Since the offering memorandum is a selling document, some of these adjustments should be regarded skeptically.

One item, for example, removes the costs of introducing a new tread line for recreational vehicles. But, elsewhere, the memorandum indicates that these kinds of replacements happen every several years, both in the military line and in the recreational line. It is very hard for me to believe that this was a nonrecurring adjustment.

Some of the other kinds of adjustments may genuinely be unique, such as the shutdown costs of a plant in Secaucus, N.J. But that involves other issues, such as how accurately those amounts are

quantified. You would not want to assume that the quantification was right, because they could easily have added legitimate recurring costs into what they consider nonrecurring.

Nowall: I noticed that they moved data processing expenses into the central office and then estimated the cost of putting a data processing system into Target Tank Tread. You have to look at that because the estimate might be too low.

Maybee: There are a lot of transactions between the parent company and the division. Data processing is one very tricky area. It seems as though all of their data processing is done centrally. Putting a separate unit in Target might involve all sorts of costs beyond simply replacing the hardware and hiring additional people. There might have to be a transition period in which you need a contract that would guarantee access to the parent company computer on reasonable terms. You might have training costs and you might have to develop new software. Those stand-alone costs could very significantly affect the economics of this transaction.

Insurance is another area where stand-alone costs have a significant impact on transactions like this. We noticed from the information that we were provided that Target is part of the parent company's self-insurance program for worker's compensation, which is an extremely onerous expense in New Jersey. It is possible that if Target became a stand-alone entity or part of your company, that the insurance companies might not look as favorably upon a self-insurance program for the new company, as they do while this company is part of Worldwide. You might be required to put up letters of credit or to make down payments against the worker's compensation insurance liability.

Nowall: Should we do a full insurance audit before we enter the next round of bidding? There are a lot of other insurance issues that I am interested in, such as environmental insurance, general liability insurance, whether there are claims against current policies, and whether I can pick those policies up. If they are part of the blanket policy of the parent company, I may have to buy my own. If so, how do I cover the history? Are you gentleman suggesting that we ought to look at all the insurance issues before we do the next round?

Maybee: I think that in all of the important instances that you just mentioned, you probably should.

Lawless: I think that with the likely claim history of this company, you have to look at these as real dollars-and-cents items. It is important to our planning to know exactly how much of the seller's insurance we can carry over and how much more you have to assume as a buyer.

Nowall: If they have blanket policies, obviously, we won't be able to purchase their insurance. But how do we cover the history? Do you think we can be added to their policies?

Lawless: We may be able to be added on to some of their policies as an additional insured. We may be able to go to their carrier and buy separate "tail" coverage, for example, for product liability claims that result from products that they make now but for which injuries or medical claims won't show up until after you have bought the company.

The Buyer Also Goes Under the Microscope

Nowall: Going back to the financials, are we talking about an audit after we sign the acquisition contract or before we sign the contract?

Lawless: That depends on how clean or dirty the papers look when Paul and the other people examine them. If it looks like their work papers are well organized and that some of these issues have been handled well, we can probably proceed with an audit while we are waiting to close after you have signed. If Paul finds a lot of funny stuff, you will want to get the audit going before you sign the contract — certainly, before you pay a hefty commitment fee to your bank.

Maybee: I agree with that.

Nowall: I would judge then that if the papers are reasonably clean, I can rely on an adjustment to the purchase price to take care of any problems. But, if the numbers look a little strange, I probably won't get enough of an adjustment. That is why it would be really important to me to do the audit before I have finally figured the price, although I know the seller is going to resist that very hard.

I am really keying my price to a flow of cash and if I can't feel comfortable that I have reasonably good numbers to support that flow, I want something harder. That's not necessarily an audit but something very close to it so I know where the price should be.

Maybee: There is one other very important point. Target is moving away from the military product line and more into the recreational vehicle product line. Recreational vehicles are quite seasonal in their demand characteristics, unlike the military programs. That is going to change the working capital needs of this company.

Global's investment bankers did not develop a month-by-month forecast of cash needs. Nor did they take into account that the change in the character of the company is also going to change the character of its working capital needs. My people and Tim's must put together a pretty good model of the working capital requirements so that you have a clear idea of your cash flows before you talk to your lenders.

Megabucks: We need cash flow projections for your company as it currently exists, and we will work with your people to do that. Then we need projections of cash flows for the combined company that will be adjusted based on our own due diligence. We will wrap them together in an integrated model and take it to the bankers with a proposed financial structure. Our due diligence will help to support all of that.

Nowall: So, the bankers are likely to be looking at my financials and what is behind those financials, doing a kind of due diligence of me as well?

Megabucks: That's right. You don't have any debt now, except for a small working capital line. Because you are going to leverage yourself up quite substantially, two due diligences will take place — what the bank does on your company plus what we are doing on the target.

Nowall: We also have to figure out who at Global is key to my business because there are some people that I might want to bring along with Target, rather than leave them at Global. I don't know how much accounting and financial work has been done upstairs. It has been pretty centralized there, and maybe they are even doing centralized buying. Is there a key purchasing agent at Global that we might be interested in?

Megabucks: One of the interesting things that we did in one transaction was to go out and solicit proposals for the various items that we would have to replace at the target — data processing, insurance, leases for properties that were retained by the parent. In other words, what it would cost to place those people and operations in new locations. I think that you could put all that in a package to figure out how it affected both your cash flow and the value that you add.

Part II: Social Costs and Buyer Protections

The financial issues are only round one of due diligence. Ahead lie even thornier issues — environmental liabilities, labor relations and employee benefit costs, deal structuring to protect the buyer against boomerangs from the seller's tough financial straits. The answers are harder to get, if achievable at all, the techniques much less proven, the unknowns much more mind-boggling, the consequences of failure more damaging.

The Vexing Decision on How Far to Go In an Environmental Audit

Nowall: Let's turn to environmental issues. What kind of an environmental review are we going to do before the next round?

Lawless: We can't cut corners tremendously in the environmental area, Steve, because you know from your existing business that liabilities and potential liabilities are enormous. Target has a manufacturing plant in New Jersey. Given the state's rigorous laws, that is a guaranteed formula for some environmental problems.

We have to get a list of all their properties and facilities and have an environmental consulting firm do what is called a "Phase-I Walk-Through" on every property. That is not going to be the end of it but it should point out the likely hot spots. If we find ground water percolating or funny smells emerging from the stream behind the plant, we will know where to look more closely, where we will need core samples, where we will do water testing, and where we will do an intensive environmental review.

Nowall: Should we carry the banker along? Whatever engineer we hire, the bank may want to hire its own, and then we will have two engineers going to the sites.

Lawless: It would be nice if we could have the

same engineer. Although, if not, then the bank's engineer should be along for the ride. Bankers are terrified of environmental liabilities because if this deal goes sour and they have to foreclose on some of these plants, they are very concerned about being liable under the federal Superfund Law.

We also need to look at Target's previously owned properties. I notice that they sold a factory recently.

But even if they haven't owned a property for 10 or 20 years, we still have to check it out. We also need to look at locations where they may have dumped their waste products.

Nowall: Why are we looking at their old properties?

Lawless: Under the current law you may have liability as a successor to their business that goes even beyond the specific assets that you buy.

Nowall: So, even if I buy assets, we are going to have to look at old properties?

Lawless: Let me ask you some questions. You are planning to run this business pretty much the way that Target has been run before?

Nowall: Yes. They have been very successful. I want to keep that cash flowing.

Lawless: Are you going to sell to the same customers?

Nowall: Yes.

Lawless: Are going to keep most of the same employees and managers?

Nowall: Yes, that's right. We are not going to change the name, either.

Lawless: Well, under those facts, I must tell you that the way the law has been moving, you are probably going to be viewed as a successor to their entire business and their whole history, including plants that they sold years ago and wastes that they dumped even before Global Worldwide owned it.

Nowall: Would I be safe if I changed the officers and directors and maybe changed the name to Nowall Tank Tread?

Lawless: I can't tell you that you can do any of those things and be safe. The only way we can be safe is to really explore, understand, and quantify these risks.

Nowall: How about the off-site liabilities? If Tank Tread gave their chemical wastes to some licensed carrier that dumped it in Kentucky, am I going to be responsible for that site in Kentucky, even if I buy assets?

Lawless: You may be, if the wastes haven't been disposed of properly. We also have to look at their records and their manifests to make sure that they haven't been dumping solvents and chemicals out on their own back forty.

Nowall: Our "Phase I" environmental survey is just a walk-through. What comes after that, and when do we do it?

Lawless: We have to see how bad it looks. If there are some really nasty spots — and we have to imagine that there will be a couple in New Jersey — we will want our consultants with the moonsuits to do some digging, some poking, and some chemical analysis.

We also must do some archaeology work. Target has an office park in Trenton that looks really beautiful, but we don't know what is underneath it. It has only been an office park for 20 years. It could have been a tannery or a refinery before.

We will look at title records going back to the turn of the century. We may look at government geological survey reports and some old aerial photographs done before World War II. We need to go back almost to the beginning of time. That is how long the environmental liabilities would go.

Nowall: I don't think I can afford all of this.

Megabucks: I don't think that you can afford not to do it. In the last year or two, most banks have required an acceptable environmental audit before closing as part of their financing conditions. Since you are leveraging up and you need the banks to finance this deal, it is going to be important.

Scant Comfort in Insurance Protection For Environmental Liabilities

Nowall: Can I buy environmental liability insurance? Is it available in New Jersey?

Lawless: It is probably going to be very hard to

buy new coverage, but the seller may have some old policies that you might be able to assume. In fact, we may consider bringing in someone who will do an "insurance archaeology" study, because a lot of policies that were written in the 1950s and 1960s, or even earlier, may still be effective. There may be policies that Global doesn't even know about.

Nowall: Will I get any protection under a comprehensive general liability policy, if they don't have environmental coverage?

Lawless: I wouldn't rely too much on their current insurance policies. Most of the environmental liabilities are excluded these days.

Nowall: Will any policy cover me for junk we find on the property that we buy or for third-party liability issues, such as if the people next door complain that their drinking water isn't good because of our operations?

Lawless: Generally, that is what the liability policy covers. Somebody is going to have to pay the cost of cleaning up a mess on the site that we buy. Hopefully, we will get some purchase price adjustment if we find out about it early.

The Balancing Act in Handling Expensive Labor and Benefits Matters

Nowall: What are the key issues in the labor area?

Lawless: There is a big union at Target Tank Tread with a wonderful health policy. They have 100% coverage on medical, dental, ophthamological, and even psychiatric care. The union contract provides that these health benefits are available to retirees from the time they retire.

Nowall: Is that on their balance sheet, Paul?

Maybee: No. The only current requirement is for those payments to be disclosed in the footnotes of the financial statements if they are material. There is some discussion among accountants about putting those kinds of liabilities on the balance sheet, but it is only at the exposure draft stage.

Nowall: But if there isn't an audited set of financials, there are no footnotes.

Maybee: That's right. So, there is no way to know.

Nowall: And that is not a liability that would have shown up on the interim financials in the bid book?

Maybee: That's correct.

Lawless: However, we can assume that the book shows the cost on a periodic basis in their cash flows, as part of their employee costs and their cost of goods sold. The real problem is projecting into the future.

You have been thinking about closing down a couple of plants and putting in an early retirement program. If you are going to offer a lot of Target Tank Tread employees the opportunity to retire at age 55, and Medicare doesn't pick up a lot of the health costs until age 65, there will be 10 years of health costs for a big retiree population on your financials. It is going to be your obligation for a long period of time.

Maybee: You probably have to show that to the bank.

Lawless: The banks will want to see whether it is on the liability side. They certainly will want to see it in the cash flows.

Nowall: Howard, do I have any ability legally to get out of some of these obligations?

Lawless: Under the union plans, there is very little chance of getting away from these groups. Even if you can bargain with the union representatives about benefits for current employees, the union has no authority to negotiate on behalf of the retired people. We need to look closely at the plans themselves. Their benefits may be vested.

Nowall: If we do an asset deal, can't we reject the contract and force the union to come back to the bargaining table and negotiate a new contract with us? Do we have a shot at getting out of the retiree benefits if we do that?

Lawless: You can reject the contracts, but the contract may be unassailable as far as retirees are concerned.

Megabucks: In some recent transactions, the selling company retained a big portion, if not all, of the retiree medical benefits. Unfortunately, Global is highly leveraged. If Global is unable to pay the claims, from a legal perspective, would we be required to pay them?

Lawless: You probably would. But beyond the legal issue, you have to think about the work force and the union that you are going to have to work with. There is more involved than strictly what is legally possible.

You have to think about your employee relations and the next round of contract negotiations. These are very sensitive issues. And we have to look at the entire union contract now.

Nowall: Can we change the retiree health programs for the non-union employees?

Lawless: Legally, you have the right to change the benefits for non-union retirees because there is no contract. But, again, you want to think about how that affects your standing in the community and your standing with current employees. It is more than a legal question. It is a public relations and employee relations question.

Nowall: What about multi-employer pension plan issues?

Lawless: There is a very cryptic footnote in the deal book about a couple of multi-employer plans through the union. That's something else that you need to be very, very careful about. Generally, a deal like this involving the sale of a division will trigger statutory, multi-employer liability for Global.

It is going to be their financial exposure, but they are not going to just take that exposure. They will want some very specific, and possibly very onerous, reps, warranties, and covenants from you as the buyer. They may even want some indemnification from you.

Nowall: Do you mean that I am not going to be able to fire anybody?

Lawless: They may want to know how many you are going to fire and to control how and when you fire people. They may want representations that you will make future contributions to the multi-employer plan. That is something that you must negotiate very carefully.

Deal Structures for Protection From Global's Financial Peril

Nowall: Just how do I protect myself from this seller? Global is very highly leveraged, and any promise it makes might be enforced in bankruptcy court rather than in a normal court. They are making all kinds of reps and warranties, and I am getting comfortable with a lot of our due diligence process, but there may be unknowns out there. There even may be some things that the seller comes up with before we sign. What do I do to protect myself, to make sure that Global pays and not me?

Lawless: Nothing is perfect, but there are a few things that we can do. The most important thing we can do to make the reps and warranties work is to hold some money back. We should not agree to pay 100% of the purchase price on the day we close or we will find ourselves in the unenviable position of having nothing but a contract claim against Global. Who knows where Global will be in the next year, or two years, or five years?

Maybee: How about a seller note?

Lawless: The banks would like it and it could serve two purposes. It can help the financial structure because you would get some subordinated debt in there. And we can make provisions in the note that allow us to offset our interest and principal payments for violations of the reps and warranties and for indemnifications.

Megabucks: We have to judge the competitive environment of this particular auction. The market has been moving toward increasing use of seller notes, contingent notes, and those types of instruments. I think there is a good chance that we could put a note in this deal to strengthen it from a financial perspective.

Nowall: Because this is a really attractive deal and the other bidders may be willing to take the risk, we could be in second place if we push for a note.

Megabucks: It is a key competitive consideration.

Nowall: Do you have a rule of thumb about how large the note should be? From my perspective, it should be as large as possible.

Megabucks: If you go higher than 10% to 15% of the purchase price, 20% at the maximum, it starts to become uncompetitive. So 10% to 15% is probably a good level, depending on the things that are of most value to you and what you consider to be the chief risks.

Nowall: Global is looking for cash to retire junk

bond debt and other debt. If we can't do the note, what else could I ask for?

Lawless: We could hold back portions of the purchase price for some period of time — one year, two years, or however long we believe it would take for us to really uncover any problems. Global is going to object to that because it wants the cash.

One compromise that we often use is to put the money in third-party hands, such as an escrow agent, like a bank. You can keep it there until you make sure that there are no problems.

Nowall: Isn't that risky if Global files under Chapter 11? Do I have some risk on those escrowed dollars?

Lawless: You do have some risk, and that is why a holdback is the best way to go. Another way to avoid the risk of a bankruptcy situation is to have Global put up a letter of credit.

Megabucks: Something else we have done is to get an agreement to monetize the note in some fashion. The seller's investment banker could help. We would put a 15% to 20% layer of subordinated debt in the deal, and then try to monetize it immediately. It is probably going to result in a diminution of value. I may sell the note at only 80% of its face value. Yet, it still is a way for the seller to get more cash in the deal.

Nowall: I have heard about something called the basket for indemnities which involves small items that I should pay for. But above that, what is the general rule of thumb on how much should be set aside or put in escrow or held back from the purchase price for the indemnification arrangement?

Lawless: We will start by asking for an aggressively large basket, such as 25% of the purchase price, and we will negotiate down to a more reasonable percentage — maybe 5%. It depends on how comfortable we are with the record and history of this company once we have done more due diligence.

Generally, the size of the indemnity is the last thing that you turn to after you have hammered out the representations and the warranties, the limits of their powers, and how long they last. We will work through all of those issues and then settle on the threshold that probably will be a percentage of the purchase price.

Nowall: How long do these promises last?

Lawless: The standards vary, depending upon the kinds of reps and warranties. Those that relate to ownership of property should go on forever. Others relating to specific legal issues and taxes have to last as long as the applicable statutes of limitations. On the more important reps and warranties, periods of one to three years are normal. The question really is, how long does it usually take in the normal course of the business for problems to be discovered? One to three years seems to be the acceptable period.

Nowall: Let's assume that during the environmental review we find some serious stuff. Should that be outside of the indemnification limit? Is that something that we should try to make the seller eat in full?

Lawless: Steve, the indemnification limit is not for problems that we discover during the due diligence process but for the problems that arise later and that we haven't discovered. If we have a big environmental problem or something like that, we have to adjust the purchase price or get an ironclad undertaking from the buyer. It is the seller's responsibility to deal with problems that are known before closing.

Megabucks: If serious means is it a deal breaker, there is only one way to handle it. The seller has to assume that responsibility. But given the financial status of Global, you have to be concerned about whether it can afford to clear up the problems or whether they somehow will come back to you and affect the profitability and the success of your company.

Maybee: That is why you must take care of it through a purchase-price reduction.

Lawless: It definitely has to be done right up front. ■

3.

WHARTON REPROGRAPHICS

How Acquirers Can Be Blindsided By the Numbers

Robert L. Filek

Even when a target's figures are totally correct, they can flash misleading signals to a buyer that doesn't check them out in detail.

Due diligence may very well be one of the most misunderstood terms in the m&a vocabulary. If I were to ask everyone involved in m&a what they thought due diligence consisted of, each would probably have a different answer. That can make it very difficult to do the job right. Because when someone in a deal asks you to lead due diligence, you are not sure what is being communicated and what you are being asked to do.

Fuzzy objectives and mangled communications invariably lead to results that may not be better than if due diligence was by-passed altogether. It is amazing how often acquirers don't do due diligence. It's also alarming. For anyone with an interest in the deal beyond the immediate parties — the people who are running the companies, financial analysts, etc. — passing up due diligence should be the first red flag. Anyone not doing due diligence is missing a great opportunity to make the most important part of the acquisition process prove true — and that is to make the acquisition a success.

It's also remarkable how the favorite Top 10 reasons for not doing due diligence persistently recur:

- The buyer already knows the industry well.
- The buyer has audited financial statements so it doesn't need to do due diligence.

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A STRONG MESSAGE

The right due diligence process should be aimed at confirming whether the drivers that made a deal attractive are really as good as they look. An examination riveted on finding only the deal breakers actually can shortchange the buyer by focusing entirely on the negative, thereby missing the opportunities for value creation, and overlooking the real soft spots that can mar the combination.

Getting behind the corporate-wide numbers, for example, is one essentiality. Figures on such elements as cost allocations, inventories, and capacity utilization may be entirely correct. But when they are dissected and reformatted to jibe with the deal drivers, the buyer may determine that the parts of the target it considered most attractive may not look so good.

- The buyer can't go wrong because the deal is just so good.
- There is a book value adjustment in the purchase price so the buyer will be protected against any problems that are out there.
- "We are only paying $1 for the stock of the company."
- The seller's investment banker tells the buyer its bid would be more acceptable if it didn't perform due diligence.
- The buyer thinks it is fully covered by the purchase agreement.
- The buyer believes it can learn what it needs to know about the target "once we own it."
- "We (the buyer) don't have time."
- The deal is overpriced and the buyer hopes to save money on professional fees to make up for paying too much.

So, why is due diligence performed?

First of all, buyer beware. Remember, the seller is selling the company. While everything in the offering memorandum may very well be true, although not necessarily, the facts are designed to make the company look better than it would if an analyst were to dig into those facts.

Maybe the memorandum will say production capacity for a multi-plant company is only at 50%. That may very well be true. But the capacity that is available may be for a product that doesn't make any money and is concentrated at a specific plant. The plant with the product line that is most desirable, that the buyer wants to grow and expand, is at capacity. The fact that the company's aggregate capacity is only 50% utilized may not have the meaning that is initially conveyed.

Controlling the assumed risk. The buyer may be paying only a dollar for the company but what is it assuming in liabilities? The buyer needs to understand that because assumed liabilities are very much a part of the purchase price. It is not paying a dollar for the company but a dollar plus assumed liabilities.

Identify opportunities. Due diligence does not have to be all negative. I don't know anyone who has bought a company lately without competing for it. Nobody wants to get into these contests without wanting to win. We don't go into deals to kill them. People want to do good deals. The bidder who approaches due diligence with the idea of finding opportunities that other people have not identified can win in competitive situations and still gain acquisitions that may exceed expectations.

That is an extremely important element to think about. Don't always classify due diligence as a negative. I find that people usually hire me the first time to find problems. But the reason I most typically get hired again is because I find solutions for those problems. If the purpose of due diligence is only to "find the deal killers," you have structured the wrong process.

Prepare for the postmerger integration. We keep hearing statistics that indicate that if 6,000 acquisitions got done, only 900 return the cost of capital. That is the real issue. It is easy to do deals. It is very difficult to make them succeed.

There is no good reason to walk away from the due diligence process and not use it as a platform to develop a postmerger integration plan. When the deal is announced, the clock starts to tick. The buyer needs a plan of how it is going to integrate the target company and make it successful when the deal is announced.

GAAP financial statements do not provide sufficient detail to evaluate all the deal drivers.

Develop that plan *during* the due diligence process, not when the closing parties are over. Time has a direct negative impact on the rate of return and its impact on shareholder value. Speed is important. Due diligence is a key way to open the door to that plan.

What should be the scope of a due diligence review? For many people it's checking the accounts receivable,

making sure that the accrued liabilities are okay, determining whether the inventory is correct, and verifying that the balance sheet is okay. The problem is that today, buyers don't usually pay net asset value or book value. The purchase price tends to be way in excess of book value, except in a few industries. So, anyone trying to validate the purchase price, which should be the goal of due diligence, should not stop at the balance sheet. The buyer has to fully understand what makes up the entire purchase price. And that goes well beyond the balance sheet.

Furthermore, due diligence focused strictly on the balance sheet may not produce much in the way of material information. If the accounts receivable reserve is misstated it may not negatively impact the deal. If the receivable reserve is understated by $1 million but has been understated by $1 million for five years, there really is no impact on the cash flow stream. The target just hasn't accounted for it the way that the buyer may have accounted for it. And it really doesn't have a deal impact.

Therefore, the buyer must understand what makes up the *entire* purchase price and not just the net assets. More importantly, the net asset issues may not really be deal issues. Don't kill good deals just because there are balance sheet issues that don't affect the deal.

What makes up the difference between net assets and purchase price? Deal drivers.

Why does a buyer pay more than net assets for a company? It may pay because of markets and market share. It may pay because of products and technology, brand names, and perhaps production capability. Management teams, cost-cutting opportunities, synergies are still other points of value. Real due diligence has to address these deal drivers.

If the purpose of due diligence is only to "find the deal killers," you have structured the wrong process.

Why doesn't GAAP (Generally Accepted Accounting Principles) get this done? GAAP financial statements do not provide sufficient detail to evaluate the deal drivers. Financial due diligence must analyze the detailed financial information beyond the financial statements to evaluate the deal drivers.

Revenue is not just revenue. Suppose the target is a high-growth software company with revenue up 25% every year. But when we cut into the components of revenue we find that all of the growth and, perhaps more than even the aggregate rate, actually is coming from resale of other people's products. The product that we think we are buying, the one that is touted so much in the front of the offering book, actually has declined in revenue or has been flat. We are not buying a high-flying software producer; we are buying a reseller that may command a different multiple than a producer. Only by getting beyond the financial statements and into the detail can that be understood.

Why is it that GAAP financial statements don't give us enough information? For one thing, GAAP financial statements rely heavily on allocations which really drive the numbers in a couple of different areas. One is full absorption inventory costing, or LIFO/FIFO average cost. Others include standard cost systems, joint and by-product costing, depreciation, and corporate charges. All of these amount to allocating expenses either to the balance sheet or to divisions and they change the look of a company. They drive the numbers in the GAAP financials — and they may not be meaningful for the purposes of evaluating an acquisition.

Here is why. Some of the allocation games involve such areas as production increases, standard cost variances, LIFO liquidations, by-product sales, and general and administrative costs.

Inventory Surges

Has anyone ever gone out to buy a company and found that it has a big increase in inventories? It is a very common situation. The reason is that a sophisticated seller who is grooming his or her company for sale will grow inventory, because growing inventory allocates their fixed cost base over more units. It reduces the per-unit cost of goods sold. It makes the company look more profitable. It is not really changing anything. It is just mathematical. It is the way that GAAP allocates the fixed cost to inventory and to cost of goods sold.

What we end up with if we buy a company like that may very well be excess quantities of inventory.

I once had an assignment to analyze a food company. Its inventories were way up, and I pointed out to the company's management that it seemed odd to me that the company would have two years worth of frozen burritos on hand. I am not an expert on food storage lengths but I wanted to get to the bottom of the matter.

Coincidentally, I had just come from a vacation in Las Vegas with a friend of mine who liked to keep his expenses down by taking advantage of the bargains at

casino buffet lines. So, when I asked the food company CFO why two years worth of frozen burritos wasn't considered excess inventory, he explained to me that there was a ready market for this product. The company sold the burritos to prisons and, you guessed it, buffet lines in Las Vegas. That wasn't a very comforting experience, but it showed that you can learn a lot of helpful things in due diligence outside of just financial matters.

The point was that the company had allocated its fixed cost base over these inventory items so the company looked a lot more profitable. This boiled down to the fact that we were really looking at a company that generated excess expectations in terms of profitability and too much inventory to deal with right off the bat.

> ***If you launch the due diligence process after the deal is already cut, you often leave value on the table.***

Public companies realize that they have the biggest problem in finding and rationalizing these kinds of problems because stock analysts are giving them only one or two quarters to prove the success of the acquisition. If the public buyer has to take a charge for inventory in that period, obviously it doesn't bode well. Even if the acquirer justifies having the charge recorded back in the purchase accounting, it still may require reduced production in those first few quarters. So, the buyer suffers a whipsaw effect when it owns the target.

Tricks in By-Product Sales

How about by-product sales? Say the target manufactures Product A and Product B. Product A may have a 40% gross margin. That is fine, but what if the only reason it has a 40% gross margin is that Product B is bearing a large portion of the joint costs allocated to it, then it is important to know that the markets for both products are solid.

A common risk in a situation like this is that a buyer may incorrectly conclude that if it just sold Product A, it would have a 40% gross margin. Not true. That 40% gross margin only exists because Product B is also sold and joint costs are allocated to it. You don't see that when you read the GAAP financial statements. You need to get under the detail and really understand what is there.

Sharing the Divisional Wealth

How about divisions? Maybe one division is a mundane contract manufacturer and another has a stellar proprietary product. It may be determined that both divisions are about equal in revenues and equally profitable, and on that basis, the buyer is willing to pay a multiple of EBIT of eight. But once the allocations are looked at in a real due diligence, the stellar product division doesn't make as much money as originally thought and, in fact, all of the profit comes from the contract manufacturer. That is because of the way the parent allocated the costs. Maybe there wasn't much in the way of SG&A (sales, general, and administrative expenses) needed by the contract manufacturer, but those costs were significantly greater for the maker of the star product. Yet, these costs had been allocated about equally based on revenue.

In reality, the target makes a lot of money with its one customer as a contract manufacturer but maybe loses money with its "stellar" product. Our eight multiple doesn't feel so good anymore. So, the buyer must get under those allocations and understand what drives them. Where is the money really coming from? And how will changes that the buyer intends to make in the integration process really impact the profitability?

Quality of Earnings

Earnings is earnings. GAAP financial statements focus on being accurate, on having the right amount of earnings. They don't tell you how good the earnings are. A sale to a customer at a high margin is just as good on the net income line as a change in the accounts receivable reserve. Clearly, there is not the same quality among those two sources.

In the quality-of-earnings analysis, the analyst needs to separate recurring impacts on earnings from one-time occurrences. It needs to identify private company expenses, and it needs to identify changes in accounting policies and procedures that are not necessarily disclosed under GAAP. Certainly, material accounting changes need to be disclosed under GAAP. But many changes are made that don't ever get disclosed, especially changes in estimates and accruals. It is not uncommon to see much of a company's EBIT being derived from changes in accruals, particularly when it has booked things like restructuring accruals.

Private-company expenses could be an upside. Anyone who looks at the earnings numbers but doesn't recognize that the entire extended family of the chairman has all sorts of perks, phone cards and cell phones,

and what have you, will be ignoring large expenses in the income statement that a new owner would not have on a recurring basis. This may not be a revelation but some of these expenses are hard to find. Some of the costs, like salaries and bonuses, are straightforward, but others really have to be sought out. It may be worth the effort because they are opportunities.

We had one situation in which a company had fantastic sales growth in a particular product line in heavy industrial machinery. When we dug into it, though, we found that part of those sales were to Eastern European countries right after the Wall came down. Clearly, the Wall doesn't come down every year! This was a sort of a nonrecurring situation and could not be depended on going forward.

What other kinds of things should be looked at? Deferral of discretionary expenses. Reversals of accruals. Nonrecurring sales. Changes in accounting policies.

Start-Up Machinations

Restructuring charges and product launch costs need considerable attention. The target intends that a product is going to be made at $2 a unit but in the first year of manufacturing, the cost is $10 per unit. The excess $8 per unit in a seller's eyes obviously is an investment and should be put on the balance sheet as deferred start-up costs. The company may be misstating earnings and not following GAAP.

In a situation like that, the analyst needs to ask the buyer a couple of questions. Will you ever be able to make this product at $2 per unit? The engineers may have thought that the cost would be brought down, but if the existing cost is $10, why is there such a big difference, even in the start-up stage, and what is the impact on forecasted earnings? The buyer needs to understand why. Furthermore, does the buyer really have good earnings here? Deferral of start-up costs is often an issue that needs to be closely examined to determine earnings quality.

Restructuring Gimmickry

Restructuring has received about as much attention over the last few years as anything else in accounting. Restructuring accruals, however, can get very big and very abusive. It is fine for a company to change its MIS approach and have some restructuring accruals related to those changes. But if there are no MIS expenses in the following years because all costs have been offset by those accruals, something must be wrong. The buyer should look for these accruals and their impact on earnings quality.

While everything in the offering memorandum may be true, the facts are designed to make the company look better than it would if an analyst were to dig into those facts.

We recently were analyzing a company, and the financial statements sort of told the story. The net income line for the three years presented was up, up, up. Fantastic growth. The cash from the operations line on the cash flow statement was down, down, down. Something was wrong. Restructuring accruals had been booked early and then rolled out in future years. But the cash the business was supposed to be producing, the core attraction in the deal, wasn't there.

Just to summarize. The traditional approach to financial due diligence does not focus on the critical issues in an acquisition. Financial due diligence must go beyond the GAAP financial statements, so the buyer understands the deal drivers critical to the acquisition.

Financial due diligence should address deal structuring issues. Due diligence should form the starting point for the postmerger integration plan. An accountant should be consulted while there still is an opportunity to modify the terms of the deal, including price, without killing the deal. Often due diligence issues can be fixed through structuring, and buyers should take the opportunity to work out these issues before the deal closes. If you launch the due diligence process after the deal is already cut, you often leave value on the table. ■

Read Very Carefully Before Signing Pre-Deal Documents

Brian J. McCarthy

Early-stage paperwork can bind deal parties but at the same time provide important protections — and even leverage — later in the deal.

The crafting of documents leading up to a definitive transaction agreement is an area in which lots of things can go wrong. So, it is important for buyers and sellers, especially in the dealmaking environment of the 1990s, to understand some of the key preliminary documents involved in this stage of the process — the confidentiality agreement and the letter of intent.

Usually the first document that is signed between a potential buyer and a seller is a confidentiality agreement. A natural tension exists at this stage. The buyer wants to see as much information as it possibly can about the business that it is seeking to acquire. The seller, on the other hand, often wants to give as little information as possible but still get the highest price. This natural tension is particularly acute if the seller is dealing with a competitor or a strategic buyer versus a financial buyer. Today, more than ever, strategic buyers are the best buying candidates. Although the most likely candidate to pay the highest price usually is a competitor, sellers frequently are reluctant to share too much information with a competitor for fear that it is merely on a fishing expedition and the hoped-for deal will not come to fruition.

You can deal with the concern about "opening the kimono" in several ways. Using strong confidentiality

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READ BEFORE YOU SIGN

Don't write off pre-deal documentation as a mere formality or unavoidable nuisance. Confidentiality agreements and letters of intent spell out important terms of the deal and can contain restrictions on disclosure, bid submissions and other deal aspects. Make sure you know exactly what's in the documents before you sign anything. Knowing the ins and outs of early-stage documentation is important to getting any transaction off to a good start, and may provide you with important protections — and even negotiating leverage — at a later date.

agreements is one of them. Generally, confidentiality agreements are two- to four-page documents that outline the basis on which confidential information will be exchanged between the parties.

The agreements specifically limit the use of the information solely to the evaluation of the proposed transaction. The parties can not use the information for any other purpose. In the exchange process, it is important to limit the number of people who actually have access to the information. Only the key people on both sides who "need to know" should have access to the information. Also, because of concerns over potential misuse of confidential information, there has been a trend in which outside advisers who are part of the deal team have been asked to sign undertakings that they individually agree to be bound by the terms of the confidentiality agreement. This creates a privity relationship between the company providing the information and the buyer's adviser. In case something goes wrong down the line, the company providing the information could go directly after the buyer's adviser for misuse of information.

If the transaction does not proceed, the agreements require that the information, including all notes and papers generated as part of the deal process, be returned or destroyed. That can be a rather comprehensive requirement. I recently received a confidentiality agreement from a firm that is well known for being a little bit long on excessive verbiage. It contained nothing less than a two-paragraph provision that required the delivery of notarized "certificates of destruction" to indicate that all of the documents had been destroyed.

In addition, confidentiality agreements usually contain a provision that there be no public disclosure concerning the existence or content of any of the discussions. However, if you are dealing with a publicly traded company, the rules and regulations of the principal stock exchanges and the Nasdaq may require disclosure of the existence of the talks despite the contractual prohibition.

Confidentiality agreements also outline the limited circumstances under which information can be given to third parties. Generally, governmental regulators like the Federal Trade Commission and the Department of Justice will enter the picture if the transaction moves ahead and is subject to the notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976. If litigation breaks out, either before or after a transaction is announced, there may be a court order indicating that documents must be turned over to the court. As a result, notice provisions and other checks and balances are put into place to deal with that scenario.

Over time, many of these confidentiality agreements have become somewhat standard. Before simply saying, "Fax it over, I will sign it and send it back to you," be sure to carefully review the agreement. There can be hidden bombs in them.

For example, they frequently have standstill provisions placed near the end of the agreement. In the standstill provisions, there is some period of time — 12 months, three years, or five years, for example — in which the recipient of the information is prohibited from buying any stock in the company supplying the information. That might be acceptable to a bidder in many circumstances but the bidder should be freed from that restriction if the target company decides to sign a deal with a competing buyer.

Confidentiality agreements usually contain a provision that there be no public disclosure about the existence or content of deal discussions.

I once worked on a transaction in which a client was trying to buy a book publishing company. We did the due diligence, had extensive meetings with the target's management, and woke up one morning to find out that the publisher had entered into an agreement with a large strategic buyer. My client wanted to submit a higher bid but was prohibited by the terms of the

confidentiality agreement from entering the bid without prior approval of the target board. Also, the target company told us that its board was not going to be meeting for the 60 days following the announcement.

My client decided that it didn't want to breach the agreement by unilaterally submitting the bid because it did not do business that way. Also, it got a little nervous about where the price level was going in the deal, so my client walked away.

Contrast that with Northrop's actions in 1995 after Grumman and Martin Marietta signed a merger agreement. Northrop, even though it was subject to a confidentiality agreement with Grumman that prohibited any topping action, made a bid proposal without consent of the Grumman board. Apparently, Northrop decided that the original agreement was probably a breach of the Grumman board's fiduciary duties because it prevented higher bids for Grumman in a sale of the company context. This purported breach caused quite a stir for a few days and changed the dynamics of the deal process. Ultimately, Grumman decided to accept Northrop's higher offer.

Here's one word of advice to companies involved in an organized sale or auction process. Although many confidentiality agreements start out in a standard form, when there are many bidders, you never know whether someone else has gotten creative in negotiating some special provisions that could give them an advantage in the process. A bidder must carefully consider its options. Should the bidder argue for a most favored nations clause? If anyone else gets better terms, like a shorter standstill or different circumstances under which bids can be submitted, should a competing bidder get that same treatment?

Sometimes, negotiating the specifics of a "custom tailored" agreement can take a lot longer than expected. I was working on a deal a few years ago as a representative of the seller and received a confidentiality agreement late on a Friday afternoon. The deal was moving fast. We anticipated that the first due diligence session and exchange of information would take place the following Monday. People were flying in from overseas to attend the meeting and review the information. The buyer in this case decided that it was going to use the confidentiality agreement to stake out as much potential leverage as it possibly could to prevent us from talking to third parties while we were in discussions with them, and to try to learn indirectly how far along we were with other potential parties. Of course, the buyer didn't mention any of this when it said it faxed the agreement to us and said, "Here's our standard form. Have your client sign it and fax it back."

An official of the selling company and I, who were in two different locations, proceeded to spend most of the weekend on the phone negotiating with the buyer's counsel. At one point, we spent nine straight hours on the telephone. I was using a hotel phone, and anyone who has made any phone calls out of a hotel can appreciate how much my phone bill was when I checked out.

The second key document drawn up before a definitive agreement is the letter of intent, or "agreement in principle." It is not used in all circumstances and there are lots of reasons why you should or shouldn't use it. Most letters of intent are not meant to be binding, so the question is, if they are not binding, what good are they? They can lead to problems for the parties involved in the transaction, particularly in a public-company context, if there is premature disclosure about the deal.

The signing of a letter of intent can create at least a moral commitment between the buyer and the seller to get the deal done.

The contents of the letter of intent generally outline the terms of the proposed transaction, including the principal terms. Is it a stock deal or an asset deal? Is it going to be structured as a merger? What division is going to be sold? What additional services might be provided on a post-closing basis? What is the amount of the consideration? Will payment be in cash or stock or notes or some combination thereof? What are the principal conditions to closing? Is shareholder approval needed to close the transaction? What key consents are needed between signing and closing? Are there any material regulatory filings required?

The letter of intent usually has a provision that says it is subject to negotiation and execution of definitive documentation and that the documentation will contain customary terms, representations, warranties, and conditions that are as consistent with similar transactions.

What is not usually in the letter of intent is a reference to any sort of indemnification obligations from the seller. I can count on one hand the number of times I have seen reference to indemnification obligations in a letter of intent. The reason is that the two companies are still in the courtship stage and any discussions about

indemnification and the potential for not paying the full purchase price at the end of the day can lead to awkward moments at a time when you're trying to get the relationship off on the right foot with lots of momentum.

The pros of using letters of intent are that they get the deal reduced to writing. Sometimes, the terms look a lot different in black and white. In addition, signing a letter of intent can create at least a moral commitment between the buyer and the seller to get the deal done. The letter can create momentum. An important factor, particularly in private situations or sales of divisions, is that the parties need a signed document to get the Hart-Scott-Rodino clock ticking with the government. Generally, the HSR act covers any transaction that is valued at more than $15 million and is between parties of relative size that have $10 million of sales or assets on at least one side of the transaction and $100 million of sales or assets on the other side. The two sides must file with the government beforehand to get clearance, which takes at least 30 days. Therefore, getting that clock going can be important. It sometimes weighs toward having a signed letter of intent.

> ***On the buy-side, the letter of intent may provide an acquirer with the first real opportunity to try to get some measure of expense reimbursement.***

The cons are significant, though, particularly in a public-company context. Because the parties have signed an agreement (and if it relates to a material portion of the assets of a company), they may have a duty to disclose that they have signed a letter of intent.

Most public deals do not involve letters of intent. However, over the past several years, letters of intent have been used in some very significant deals. The parties decided that because of the complexity of the transaction, the time it would take to negotiate the long-form definitive agreement, and the widening circle of people getting involved, they would use a letter of intent.

The most famous example was the Bell Atlantic-Tele-Communications Inc. deal, which was announced with only a non-binding letter of intent. Guess what? It wasn't binding and ultimately the deal didn't happen. The complexity of actually getting through the definitive agreement was too much for the transaction to bear.

Incidentally, on the buy side, the letter of intent may provide an acquirer with the first real opportunity to try to get some measure of expense reimbursement. Now, this changes in every transaction. It has a lot to do with who has the leverage in the transaction. It is probably the first legitimate point in time at which a buyer can tell the seller, "We are going to commit our resources to go down this road together. However, if you sell to someone else or if I find out some things in the course of due diligence that have been misrepresented to me and that change my opinion about engaging in this transaction, I want to have my expenses reimbursed." The buyer is not always going to get the expense reimbursement, but this is the first opportunity to try.

So, knowing the ins and outs of early-stage documentation is important to getting any transaction off to a good start, and may provide you with important protections — and even negotiating leverage — at a later date. With well-drafted confidentiality agreements and letters of intent, the parties can move toward hammering out the definitive agreement and, hopefully, a successful deal. ■

Are You Getting What You Pay for In an Acquisition?

Robert C. Byczek

Losing sight of specific objectives in a deal can trigger a chain reaction of mistakes — the wrong target, the wrong price, and fouled up operations.

In the face of burgeoning global competition, it is necessary for companies to increase productivity, advance their technologies, and become more competitive. In the past, companies had the luxury of building a business over time, but this is no longer a viable option, and many businesses are turning to mergers and acquisitions to achieve competitive advantage.

Shareholders of both private and public companies are concerned about not keeping up with the competition, which can in turn lead to a reduction in shareholder value. This concern has turned many companies that had previously refrained from m&a into active participants in the mergers and acquisitions market.

Unfortunately, because of the increase in activity and the timing pressures of the m&a market, many companies jump into the merger and acquisition process without fully understanding it — and that is where mistakes are made. The consensus of the m&a research performed by Duff & Phelps and other consultants is that most transactions fail to meet their original financial and non-financial objectives. This risk can be minimized, however, by creating a well-thought-out acquisition strategy and sticking with it.

A thoughtful acquirer can improve its odds for success by defining its strategy, clearly identifying the role of specific acquisitions in implementing this strategy,

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EYES ON THE BALL

Start challenging the conventional wisdom that due diligence should be focused on finding the financial flaws in the acquisition target. Instead, use due diligence to give the target such a thorough once-over that the investigation discovers whether this is really the company for you. Begin by drafting an acquisition strategy, stick with it, and then figure out the real objective — wider customer base, new technology, product-line expansion, market share, etc. — in a specific deal. Finally, answer the question of whether the candidate under review has the products, the know-how and the people to fulfill the objective.

and determining whether a strategically sound deal will enhance value through recovery of investment.

A good place to begin is the strategic considerations involved in the due diligence process. Many companies deal very well with the technical aspects of due diligence and have advisers to guide them through the process. However, without a well-planned strategy, due diligence may not produce the desired results.

As part of its strategic self-evaluation, an acquiring company must ask itself some critical questions before beginning the m&a process. What is the company's strategy? Do all members of the operating management team fully understand the current strategy of the company and its strategy going forward? Does the team understand both the financial and strategic motivations behind a specific transaction?

Obviously, there are many financial reasons for pursuing an acquisition, but the primary underlying goal for both public and private companies is to increase shareholder value. Regardless of whether a company is private or public, it is important that the management team evaluating acquisition candidates be fully apprised of the overall strategy designed by top executives. The evaluation team can then implement the strategy and challenge its motivations. The evaluation team should know precisely what the company is trying to achieve through acquisition — improved technology or expanded distribution, for example — and then determine whether a specific acquisition candidate offers the desired resources.

Emphasis also must be placed on the ability of an acquisition to promote value creation. A company needs to determine whether, over time, it will be able to recover its investment in an acquisition. Often, companies do not recover their investments because they wind up paying for the acquisition several times: once when they buy the business, a second time when attempting to capture synergies after the deal closes, and again when synergies don't come to fruition. This further points to the need to develop a strong strategy before pursuing a transaction.

We recently worked with a mid-sized, privately owned manufacturer of electronic controls that was looking to make an acquisition. Due to intense competition in the marketplace, the company needed to increase its technological capabilities. Further, its two primary customers, Kimberly-Clark and Johnson & Johnson, informed the company that they would not continue to purchase its products if it did not upgrade its technology. These customers expected the upgrade to occur on a worldwide basis and wanted it to take place within a limited time frame. Although the company could have upgraded its internal technologies, it decided to accelerate development through acquisition.

Several companies were identified as acquisition targets, but one, another middle-market firm, emerged as the leading candidate. Based on this company's descriptive memorandum, it appeared that acquiring the company would enable our client to achieve its goals. Both Kimberly-Clark and Johnson & Johnson indicated that they approved of this company as an acquisition target.

With a target identified, the next step involved performing technical due diligence. Because of the importance of this acquisition, our client wanted to make sure that every member of the management team involved with the deal had a complete understanding of the candidate's abilities. To achieve this, the evaluation team was divided into three groups.

One group consisted of our client's engineering staff which spent a good deal of time with the engineering staff of the target. This group discovered that R&D spending at the company had dropped in the past couple of years and was told that the target's technology was so strong that it was unnecessary to continue spending the amount on R&D that had been spent in the past. (We later recognized that the candidate's management was positioning the company for sale and had cut back R&D spending to increase bottom-line earnings.) Additionally, our client's engineering staff reviewed the candidate's key product over the past five years. They discovered that the product had been revised numerous times, but that in the previous two years modifications had dropped off suddenly. The technical team noted this change and filed it for further review.

While our client's engineering staff was analyzing the technical side of the target, its financial staff was evaluating the target's financials. The financial people were pleased with the overall financial projections of the company. They were somewhat concerned, however, by the fact that very strong growth was projected over the next few years, because this was the basis for demanding a very high price from an acquirer.

The third group within the evaluation team was made up of members of the client's marketing staff which spent time with the candidate's sales and distribution people. While looking through sales reports, the marketing people began to notice that some customers were complaining about the target's technology and were not pleased with the way in which the company's product affected their efficiency. This did not cause the marketing team any immediate alarm, but they noted the complaints for future reference.

This team approach to due diligence noticeably altered the effects of the process. In many acquisitions, the individual groups, such as engineering, finance, and marketing, submit separate reports to operating management. Taken individually, reports of the problems such as those described here would not likely raise any eyebrows. However, the fact that our client's operating management analyzed all of the reports collectively and worked with the evaluation team as a whole allowed them to create a more realistic picture of the target company. The problems discovered by the engineering, finance, and marketing teams may have fallen through the cracks if the reports were considered separately. Together, however, the incidents pointed out that there might be some cause for concern.

Problems discovered by the engineering, finance, and marketing teams may have fallen through the cracks if the reports were considered separately.

The information provided by the evaluation team enabled management to recognize that the candidate was at the forefront in terms of current technology. But the target was not keeping abreast of emerging technology and its competitors were beginning to leapfrog the company. If our client completed the acquisition based on the seller's terms, it would be paying a high price for an overly aggressive sales forecast. The client then would have the burden of putting more money into the acquired company — about as much as the purchase price — to develop the technology to the point it would need to reach in coming years.

Our client continued to talk to the target, but with an eye toward paying a much lower purchase price than originally expected. The drawbacks discovered through the due diligence process led our client to begin looking at other candidates in the marketplace. Many of the alternative candidates were smaller and less prominent but they had already developed the technology necessary to complete our client's strategy.

Attention to strategy, like that just described, can positively impact many aspects of the m&a process. In addition to guiding the due diligence process, a solid acquisition strategy can help an acquirer determine a realistic price for its prospective acquisition.

Most buyers look to the m&a marketplace to steer them toward the appropriate price for an acquisition. Although market price can serve as a useful pricing guideline, it only relates to half of the equation. Market price cannot help a company determine the value of an acquisition. This is why Duff & Phelps generally recommends that our clients prepare their own valuation models in an attempt to relate price to value. Advisers can help a company with the technical aspects of a model, but nobody knows a business better than its management. That is why it is critical that management take steps to negotiate the value of a potential acquisition, instead of merely focusing on price.

It is also necessary to go beyond valuing a target company on a stand-alone basis. An acquirer needs to isolate the key assets at the target company that will satisfy the primary goals of the acquisition. These assets should then be theoretically blended with the acquirer's operations business, i.e., distribution facilities, plants, and technologies. Projections should be run on the effects that these assets will have on the combined company's near-term, intermediate-term, and long-term income statements. It is also very important for the acquirer to understand its competitors and to gauge how they would be assessing the valuation. All of this can help a buyer to determine what its offering price should be. The aim is to not overpay for the acquisition because the greater the overpayment, the less chance there is of creating value over time.

Acquirers typically try to create value and recover investment through internal cost reduction. Advisers and companies tend to assume that an acquirer can start cutting expenses, unilaterally, especially in a consolidation play where two competitors are blending together. Often the businesses of these two competitors are not

exactly comparable, which can lead the acquiring company to make some initial mistakes.

In sales, for example, there tends to be an assumption on the part of acquirers that they do not need to have two separate sales staffs. They do not realize that sales are tied to two very important variables:

- The relationships the sales staff have with its customers and
- Technical knowledge.

A full understanding of the target's sales and distribution networks, its personal customer relationships, technology as a driver of sales, purchasing policies, and other key aspects of sales and marketing is required before a buyer can make decisions regarding the necessity of a dual sales force.

General administrative areas, while somewhat easier to focus on, also must be analyzed before any immediate decisions pertaining to them are made. When an acquisition results in the blending of two companies, the new entity has two controllers and two purchasing managers. This may seem redundant, but it is not safe for an acquirer to assume that the only course of action is to let one or the other go. This is especially true in regard to purchasing. The cost of purchased materials can be very significant, making it important that the buyer refrain from unilateral decisions before determining the most practical cost-saving steps.

A 10% cost reduction may not really be material. Conversely, a 10% reduction in revenues can be devastating.

Cost savings must be quantified and a reasonable time frame for achieving such savings must be developed. Acquirers often are surprised in the first couple of quarters following a deal that it takes longer to realize expected cost savings than they generally anticipated. For this reason, it is often useful to turn to technical advisers who have the ability to quantify and gauge the timing for cost savings. Suppose an acquirer wants to terminate a large number of employees because it assumes the cuts will result in substantial short-term savings. An adviser will be able to determine the validity of this assumption by looking at the offsetting outlays in benefits, retirement programs, and labor contracts. Any company looking for huge cost savings may face contractual obligations that it did not focus on. It is important to avoid making uninformed decisions and to include real cost savings in the valuation model.

Often buyers, wrongly perceive due diligence strictly as a means of discovering the faults of a target company. Due diligence is an opportunity to get to know the company, which includes identifying its key assets and profit drivers.

Due diligence tends to focus on the expense side of a company which, while not unimportant, is not the primary area that needs to be examined. It is our opinion that a 10% reduction in cost is not really material. Conversely, a 10% reduction in revenues could be devastating. Due diligence provides an acquirer the opportunity to focus on how it will maintain the revenue base on the day the deal is completed.

Due diligence also provides an excellent opportunity for an acquirer to evaluate its target's management team, especially middle managers. These managers should be closely observed and, as the acquisition process moves forward, they should be informed of the strategy for the combined business. An acquirer must start to build common ground in the early stages of the acquisition process so that when the deal is consummated, the buyer is not considered an enemy.

Developing a positive rapport with the management of a target company can be essential to the success of an acquisition. We recently helped a client acquire a $75 million company and throughout the process we spoke to three or four senior executives. Every time we asked them a question, they would refer us to Mark, the plant manager and head of operations who was not an officer of the company. Eventually, we figured out that every time members of the due diligence and evaluation team needed information on something, whether it had to do with accounting, purchasing, sales, or overall business, we had to go see Mark.

It became clear to us that Mark was really the key person in the business, so we began to build an allegiance with him. We got to know Mark and his motivations because we realized it would be necessary to keep him after the acquisition took place. Again, the acquirer's understanding of its strategy was essential.

Acquirers should not be reluctant to spend a fair amount of time and money on an overall evaluation of the target and should not be afraid to walk away if in the end the target is found wanting. Many buyers think it is easier to overpay for a business than to rethink the transaction if a target company cannot fully satisfy the acquirer's need. This is one of the reasons that many acquisitions do not succeed. During due diligence is when a buyer should consider all of its options that will enhance its position in the market. ■

Getting the Biggest Marketing Bang From the Merger

Mark N. Clemente and David S. Greenspan

Up-front acquisition planning should determine whether combining companies have the stuff to cross-sell and create new products.

More and more m&a transactions today fall into the category of "strategic deals," combinations designed to produce synergies that will foster long-term competitive advantage for the merged company. The proliferation of strategic deals has spawned an important new element of the merger and acquisition evaluation process in the form of marketing due diligence. That includes identification of business development synergies that are attainable after the partners integrate operations and map out tactics to put those synergies into action at the close of the transaction.

The increased focus on marketing due diligence is consistent with an emerging tenet in 1990s m&a. Cost-reduction synergies, which are often realized through economies of scale, are becoming much less important than strategic synergies that can generate near-term and long-term revenue growth. The shift in emphasis is consistent with a number of business development studies. Some, for example, have found that revenue growth creates far more bottom-line expansion than cost cutting. And studies more directly linked to m&a have determined that the most successful integrations are externally driven, that is, directed at providing seamless service to customer markets.

As a result, strategic marketing consultants are joining the investment bankers, lawyers, CPAs, and others who

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AT THE END OF THE RAINBOW

If a strategic acquisition looks great on paper, it may be time to figure out if the combined company really can deliver in the marketplace. Complementary skills, compatible customer bases, and perceivable synergies are fine. But whether they can be harnessed to create value may depend on marketing smarts and vision.

Determining whether a deal really makes sense may require in-depth marketing due diligence before going ahead. Do the partners have the ability to cross-sell their products and services to customers? Can they team up to generate new products that will score? Are there future opportunities not even envisioned? The answers may impact a host of deal phases ranging from pre-deal strategy to forging a truly integrated, market-focused company from day one.

istorically have comprised the due diligence team. ıternal corporate acquisition teams also are finding the ıput of m&a-focused marketing specialists to be valu- ›le in assessing the business development potential of ifferent candidates for acquisition. By all accounts, ıarketing due diligence specialists are bringing a fresh erspective and analytical eye to pre-deal planning.

Standard due diligence focuses in large part on a tar- et company's earnings, cash flow, and financial assets nd liabilities and how they meld with the acquirer's alance sheet. Usually, marketing-related variables are xamined, although invariably limited to the target's roducts, services, markets, and competitors.

Marketing due diligence, by contrast, probes in sig- ificantly greater depth by weighing the macro-charac- ·ristics along with other qualitative and quantitative tributes of both the acquirer's and the target's business evelopment systems and capabilities. The primary goal to unearth post-deal revenue-generating opportunities ıat can be mined long after initial expense cuts have een achieved.

Marketing due diligence involves not only looking at oth firms' products but checking the promotion efforts ıat contributed to those products' past successes. It ıvolves not only examining both firms' markets but ıe macroeconomic and micro-environmental trends ıat will affect the markets' future characteristics and ynamics. It involves not only studying each firm's cus- ›mer base but analyzing the extent to which either or ›th have been — or can be — penetrated with different product and service offerings.

Traditional due diligence evaluates the target's marketing-related intangible assets, e.g., customer lists, licenses, trademarks, franchises, and the vague and difficult-to-quantify category of "goodwill." Marketing due diligence goes beyond these areas to search for often overlooked qualitative intangibles at the merger partners. These include:

- Overall marketing and sales infrastructures, including people, processes, and programs;
- Sophistication in strategic and marketing planning and the ability to actually achieve the goals cited in sales and marketing plans;
- Effective use of modern technology in marketing and sales applications; and
- Interactions with key constituencies and sales channel intermediaries and the value in those all-important relationships.

Comprehensive marketing due diligence also helps expedite postmerger integration of the business development function. By identifying key revenue building strategies — and planning for their swift attainment on consummation of the deal — the merged company can begin maximizing its sales potential from day one. Conversely, inadequate pre-deal planning can severely delay the company's ability to operate at its peak marketing and sales capacity.

The expression "time is money" is appropriate in capitalizing on marketing potential. If sales in the postmerger environment are projected at $10 million a month, a two-month marketing integration period will send money flowing to the bottom line a lot faster than if the implementation took six months. Measured by raw sales alone, nonproductive opportunity costs would be $40 million.

Marketing due diligence searches for often overlooked qualitative intangibles at the merger partners.

The process and benefits of marketing due diligence are best illustrated by descriptions of actual acquisition projects on which we have worked. However, it is helpful to first introduce a new concept that provides a frame of reference and represents the methodological underpinnings of this approach to evaluating m&a opportunities.

Revenue Enhancement Opportunities

Achievement of synergies is a primary goal of most mergers or acquisitions. But what exactly are synergies? To answer that question it is important to note initially that there are different types of synergies.

Certainly, every deal offers different financial and situational benefits to the companies involved. However, the growing distinction between "strategic" and "financial" deals requires that we view the term synergies in a new light. The strategic m&a perspective has given birth to a new concept that lends insight into the pre-deal planning process and the ways to measure success in the post-deal environment. That is the Revenue Enhancement Opportunity (REO).

In standard due diligence, the attributes of the acquirer and the acquiree are compared side by side. Conventional analyses typically uncover operational synergies that lead to cost-reduction opportunities via the elimination of duplicative operations, processes, and personnel. Concentration on expense-related areas may make the deal financially beneficial in the near term.

By contrast, marketing due diligence seeks to ferret out REO synergies, the sales and marketing-related opportunities that collectively make the deal financially rewarding in the long term.

Cost-reduction synergies are created when there are overlaps between the companies coming together. Once an overlap is identified, the weaker of the duplicative elements is eliminated. The post-merger benefit is represented by the idiomatic numerical equation of 2 + 2 = 3.

Identification of overlaps sparks quantifiable savings that bolster the financial justification for the union of two companies. In public companies, this may be evidenced by a short-term jump in the acquirer's stock price, if the market is convinced that costs can be cut and the buyer's per-share earnings won't be diluted, as well as the obligatory reports in the press of an eventual gain in shareholder value. However, long-term shareholder value is by no means a given unless true REO synergies lie at the foundation of the deal.

REO synergies result when the skills and resources of the two companies create complementary overlays that spawn revenue-generation opportunities. An overlay occurs when two attributes combine to forge an entity whose whole is truly greater than the sum of its parts. Here, the numerical analogy takes the form of the equation 2 + 2 = 5.

In their purest form, overlays give life to a process of both savings and revenue enhancement. In fact, in strategic deals, near-term expense reduction synergies are precursors to the cultivation of a long-term REO process. When this process is put into action, and both cost reductions and revenue enhancements result, true shareholder value can be ensured for years to come.

The process of identifying REO synergies and devising the tactics to realize them effectively focuses on the needs and attributes of the combining companies, e.g., industry characteristics, purposes of the deal, skills, etc. Here are some examples:

Converging Markets

A major computer hardware and software manufacturer was exploring the acquisition of a publishing company with the aim of creating a variety of user-support materials in printed form. In the course of marketing due diligence, we identified the opportunity to establish a separate marketing communications function and a subscription-based line of computer publications for consumers and businesses worldwide.

We developed a strategic plan, detailing the product concept and market positioning, staffing requirements, operational procedures, and production timetables. The personnel component took into account the disparate, yet complementary, skill bases of employees at the two companies. The basic plan was supported by sales, marketing, and communications strategies to distribute and promote the new publications in domestic and international markets.

The idea that "time is money" is appropriate in capitalizing on marketing potential.

The project provided a bridge between two companies that operated in markets that were traditionally separate but increasingly can be served by a single player. The program was set to go early on and accelerated implementation of the strategies spurred immediate sales.

Expanding Skills and the Customer Base

A prominent health care consulting company was investigating the acquisition of a research firm that conducted market studies on the health care industry in a plan to expand its arsenal of services for basically the same customer base. Our job was to assess the viability of the target's products and the strength of its marketing and sales infrastructure.

The work led to identification of several hidden marketing opportunities as well as marketing and sales-related vulnerabilities that had a direct bearing on the negotiations and the ultimate purchase price premium. We found weaknesses in the product life cycle stage of the target's core product. The product was entering the "mature" stage because of the imminent introduction of a similar offering by competitors, a situation of which the acquirer was not aware.

The unforeseen sales opportunities, or REOs, took the form of a new series of survey products that could be developed by linking the health care subject matter expertise of the acquirer's consultants with the statistical aptitude of the target's research specialists. Another REO was driven by our experience in developing services that could be cross-sold to the merged companies' original client bases. This involved creation of an employee research and internal communication function that could be customized to the merged companies' clients and offered on an outsourcing basis.

Geographic Expansion

As part of a deal designed to give an eastern-based financial services firm a presence on the West Coast, marketing due diligence focused on a particular acquisition candidate's level of market awareness and its business development track record. The investigation unearthed distinct weaknesses in both areas.

Our analysis revealed widespread turnover of the target's sales force and, hence, erratic sales results. The primary reason for the frequent defections was the lack of promotional support from an understaffed, inexperienced corporate marketing group. The lack of marketing muscle had other detrimental effects such as low market awareness and a high level of buyer confusion about the company's service line. Citing these shortcomings, our client was able to negotiate a lower purchase price than the one it originally set forth.

A more enduring recommendation, based on the discovery of the marketing soft spots, was to outsource most of the target's business development function. Our suggestion to employ independent sales agents and marketing services agencies helped lay the groundwork for immediate REO realization — while the lengthy process of rebuilding the internal sales force and marketing function took place.

The term "due diligence" denotes pre-deal analyses conducted by one company in its examination of another. In fact, much of the foregoing relates to marketing due diligence performed by the acquirer. Marketing due diligence, however, is equally valuable to companies on the sell side.

Consider the following situation. An anxious seller retained our firm in the midst of negotiations to assess his firm's sales and marketing resources and skill base. Our findings revealed hidden marketing strengths that could result in strong REO synergies with the acquirer and projected revenue gains under different timing scenarios. Armed with additional information on these intangible marketing assets, the seller was able to negotiate a higher price than initially offered.

Identifying REO synergies requires an acute business development focus that takes into account financial variables but specifically keys on the marketing strengths and weaknesses of m&a candidates. REO synergy analysis begins with a comprehensive evaluation of the acquirer's own business development infrastructure. Target companies' marketing capabilities are then measured against that.

In addition to a high-level assessment of marketing and sales variables, detailed marketing intelligence also must be gathered. Data are culled from a wide variety of public and private sources. Face-to-face interviews with key players in the marketing process, e.g., managerial and creative executives, outside consultants, customers, and channel intermediaries, confirm or refute initial findings and hypotheses.

The marketing due diligence process brings to light challenges and opportunities that previously went unnoticed. Today, however, these issues typically mark the difference between a deal that simply scores in a near-term mathematical sense or endures as a long-term business success.

> **The merged company may never realize its strategic vision after a stumbling start.**

Certainly, the basic numbers must satisfy all the parties involved. But the calculations cannot speak only to the short-term. Identifying REOs and planning adequately to realize them put the merged entity in a position to begin focusing immediately on its market(s) in pursuit of long-range revenue objectives.

Setting Priorities in the Pipeline

It is important to set priorities when developing plans to capitalize on REO synergies. Not every opportunity should be acted on immediately, nor is that feasi-

ble. Ideally, a loaded and ordered pipeline of executable REOs will allow the merged entity to remain focused on long-term results while delivering incremental successes to stakeholders in the short term.

Consider the case of two regional retailers that merged to create a national chain. Consolidating their customer information records into a powerful data base for direct-marketing purposes was a distinct REO synergy. So, too, was the ability to establish newly revamped retail outlets under the merged company's new banner. Both actions had the potential to generate revenues, yet the data base marketing project was able to yield income quickly. By contrast, the complex task of store redesigns and mass media promotions to create name awareness and build store traffic was more time-consuming.

In most cases, the basic strategy should be to invest in REO synergies that will generate immediate revenue while concurrently planning to realize the synergies that will require more time, resources, and capital.

While marketing due diligence concentrates on delivering an instant payoff, it will, if done properly, develop a full pipeline of revenue enhancers that can be executed sequentially. Its first objective is to help forecast and deliver revenue growth immediately after completion of the deal. Assigning priorities within a basket of prospects allows for ongoing achievement of successive REO synergies at appropriate points on the post-deal integration timetable.

Acknowledging the pipeline concept in the premerger planning stages is critical. It allows the acquirer to focus on REOs that will deliver incremental gains to stakeholders over the short-term while never losing sight of the REOs that will produce a steady stream of future sales.

In the past, marketing due diligence issues were viewed as peripheral. In the context of strategic m&a of the 1990s, they are central. Marketing due diligence supports each aspect of the pre-deal planning process by:

- Providing qualitative and quantitative information that can be factored into statistical analyses of a target's current value and future contribution as part of the merged entity.
- Generating significant additional data for computing acquisition premiums and financial forecasts.
- Identifying strategic synergies aimed at revenue generation, not just cost reduction.
- Facilitating postmerger integration of the business development function to spark speedier attainment of sales increases and bolster chances for ultimate success of the merger itself.

That last point is critical. It relates to the widely held belief that adequate up-front planning leads to expeditious postmerger integration. Integrating all corporate functions in the wake of a deal is an enormous undertaking, but business development is the most important element of the pack. The merged company must have its marketing organization and plans in place so it can launch combined business development programs into its markets on consummation of the deal. A delayed or problem-plagued rollout can cause the merged company to lose momentum, market share, and the backing of customers, prospective customers, and shareholders. Even worse, the merged company may never realize its strategic vision after a stumbling start.

When both cost reductions and revenue enhancements result, true shareholder value can be ensured for years to come.

Clearly, the merged company has to "hit the ground running" from a marketing and sales standpoint. In the context of strategic mergers and acquisitions, however, the "run" is a marathon, not a sprint. Effecting expense reductions is an important, albeit short-term, consideration. Realizing and ranking revenue enhancement opportunities by priorities is the critical factor in ensuring the long-term viability of the deal. ■

A Real-World Focus In Calculating Terminal Values

Paul F. Barnes

Determining the largest part of most purchase prices requires complete understanding of the target's competitive position in its market.

All of us are familiar with the basic tenets of discounted cash flow (DCF) analysis in acquisitions. We analyze the target company, try to project cash flows over a specific forecast period, attempt to determine a terminal value or residual value at the end of that forecast period, and apply a discount rate to the projected cash flows and terminal value to determine their present worth. The calculation of terminal value, which usually represents 50% to 75% (if not more) of the total business value, often is inconsistent with the implicit assumptions embodied in the projected cash flows leading up to the terminal year and/or the realistic performance expectations of the business subsequent to the forecast period. I would like to suggest some analytical techniques that can be applied in the terminal year calculation to derive more realistic and internally consistent pricing conclusions.

As a general rule, DCF analysis is conducted on a debt-free basis, i.e., net income exclusive of interest cost and the associated tax shield (or earnings before interest and taxes (EBIT), net of tax) plus depreciation less capital expenditures and incremental working capital requirements. A debt-free DCF model provides the cash flow available for distribution to all stakeholders, both debt and equity, and is not impacted by either the current capital structure of the target or its postacquisi-

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INTO THE FUTURE

At a time when strategic acquisitions predominate, many acquirers are shooting themselves in the foot by doing a slipshod or arbitrary job of calculating terminal values in discounted cash flow analysis. Not only is the terminal value usually the largest component of a purchase price but a major barometer of whether a deal will fit the classic purpose of a strategic acquisition to create value over a long period of time.

The key to determining an appropriate price based on the target's long-range prospects is gauging its competitive position in its product or service market and whether that power and attendant financial returns can be sustained over the long haul. Based on that real-world understanding, an acquirer can apply its analytical results to pricing through a series of formulas that incorporate projected growth, costs of capital, and new investment requirements.

tion capital structure reflecting the acquisition financing. Ultimately, the present value of the debt-free cash flows (or the business enterprise value) will be reduced by the assumed debt of the target to arrive at the fair market value of the target's equity.

Consistent with a projection of cash flow available to both debt and equity holders; the discount rate generally is the weighted average cost of capital (WACC), a blend of the optimal capital structure of the target, its relative debt and equity, and the costs of those two components. The cost of equity generally is determined through the capital asset pricing model.

Considerable time and effort usually are expended in analyzing the historical financial results of the target and examining its budgets and business plans as well as relevant industry data to derive a credible projection of cash flows for some finite future period, generally between three and seven years. Similar efforts are spent on estimating the appropriate capital structure and the costs of its components to estimate the WACC.

However, after determining the forecasted cash flows and the WACC, all too often terminal value, representative of value from one year after the forecast period into perpetuity, is arbitrarily assessed. Some common applications include an exit multiple (usually based on current market multiples), capitalization of an earnings or cash flow parameter at a rate that may or may not include a long-term growth component, liquidation value, etc. Unfortunately, although terminal value may represent more than 50% of the value conclusion, it typically warrants only about 10% of the intellectual and analytical attention. If more attention were devoted to the terminal value computation, I believe, buyers could develop more confidence in the pricing of acquisition candidates.

The starting point for a more comprehensive and disciplined approach is a series of terminal value equations. The first has been referred to as the Value-Driver formula, or:

$$\frac{DFNI\,(1-g/r)}{WACC-g}$$

where DFNI is Debt-Free Net Income; g is the expected long-term growth rate in DFNI; r is the expected rate of return on net new investment; g/r is the proportion of DFNI investment in additional capital; and WACC is the weighted average cost of capital.

This terminal value equation is expressed in terms consistent with those included in the forecast period and provides for the flexibility to evaluate the relationship of the key value drivers both in the projection and into perpetuity.

An algebraically equivalent equation (as long as the long-term growth rate [g] is less than the weighted average cost of capital (WACC)) is:

$$\frac{FCF}{WACC-g}$$

where FCF is Free Cash Flow.

Generally, free cash flow is debt-free net income less the investment in incremental working capital less the investment in capital expenditures (net of depreciation). In this equation, free cash flow is capitalized at a rate equivalent to the weighted average cost of capital minus the long-term growth rate. These equations, although equivalent, provide different perspectives and insights. The Value-Driver formula expands the FCF terms and expresses it in terms of operating income, the prospects for long-term growth in operating income, and the rate of return on net new investment in capital necessary to fund that long-term growth. It allows the analyst to provide for a different growth/return matrix into perpetuity than the one that is embodied in the finite projection period.

For example, it is critical to evaluate whether, given the industry in which the target operates, the rate of return on incremental investment established during the initial forecast period can be sustained forever. One of the deficiencies of applying some of the aforementioned residual calculations, such as exit multiples, is the incorrect assumption that the target will enjoy a rate of return into perpetuity that is equivalent to what it

earned over the five-year forecast period.

In certain circumstances, that may not be a completely invalid operating assumption. If the target possesses significant proprietary technology, a significant brand name presence, or a significant market position that will allow it to enjoy above-average returns, it may

It is critical to evaluate whether, given the target's industry, the rate of return on incremental investment can be sustained forever.

be appropriate to consider an extraordinary return on incremental investment. In most cases, however, there is a finite life to that competitive advantage, and over time competitive market forces will tend to restore an equilibrium so that extraordinary rate of return will be competed down to a level of return on net new investment equivalent to the cost of capital.

At that point, a third terminal year formula is applicable:

$$\frac{DFNI}{WACC}$$

This is the algebraic equivalent of the Value-Driver formula when the rate of return on net new investment (r) equals the weighted average cost of capital (WACC).

It's not always obvious what the rate of return on net new investment should be for any given company. One method of addressing that within the context of pricing a target is to calculate the terminal value in two ways. First, capitalize free cash flow (FCF) at the weighted average cost of capital (WACC) less the long-term growth rate. Then calculate terminal value by capitalizing debt-free net income (DFNI) at the WACC.

If those two computations are close, it is indicative of an implicit assumption that the rate of return on net new investment is about equal to the cost of capital. However, if the free cash flow capitalized at the WACC is much higher, then the analyst has assumed, intentionally or unintentionally, that the target can enjoy arate of return on net new investment that is significantly greater than its cost of capital and can continue to enjoy it for an extended period of time. If that disparity exists, the analyst needs to evaluate the results in light of the target's attributes. Is the difference just an unfortunate computational result of using the incorrect terminal year formula? Or is it a realistic expectation of the target's performance vis-à-vis the industry in which it operates?

Those two computations will provide benchmarks on which to further evaluate and sensitize the estimates of long-term growth and rate of return given the attributes of the target and its relative competitive position in the marketplace.

A final approach to determining terminal value, which is commonly used but inappropriate in many cases, is to assume that the target can grow at a rate equivalent to the forecast rate of inflation. The conclusion is then drawn that debt-free net income (DFNI) should be capitalized at the real, rather than nominal, weighted average cost of capital (WACC), resulting in the following formula:

$$\frac{DFNI}{WACC\text{-}g}$$

This formula is derived from the Value-Driver formula when the rate of return on incremental investment approaches infinity. More importantly, it assumes that long-term growth can be realized without any net new investment. This is not realistic for most businesses.

It seems obvious that in order to grow, investment is needed. The determination of the appropriate terminal year value needs to recognize that axiom as well as incorporate the appropriate relationship among the value drivers. ■

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WHARTON ... GRAPHICS

The Winding Trail: A 30-Year Profile Of M&A Dynamism

Martin Sikora

Since the dark days of the post-conglomerate era, mergers, acquisitions, and divestitures have powered their way to the cutting edge of business development.

In one of the biggest business stories of 1995, the far-flung ITT Corp. decided to split into three separate companies related only by lineage and part of a name. When all of the complex spin-off maneuverings are done, the company's banner will be carried forward by a new ITT Corp. owning hotel and gambling operations, ITT Industries in electrical and electronic equipment manufacturing, and ITT Hartford with insurance and financial services businesses.

In a larger sense, the ITT break-up is one of the most dramatic symbols of just how mergers and acquisitions have evolved and progressed over a 30-year period that has encompassed the lushest of dealmaking times interspersed with some of the most arid.

Moreover, the tripartite divorce underscores how the highest-profile, most glowingly acclaimed deals of the past can be undone at some point in the future if they can't endure the proverbial test of time.

To many, ITT epitomized the conglomerates that drove dealmaking at a fever pitch during the late 1960s. If it wasn't the only practitioner of the concept that acquiring and running a basket of totally unrelated business was the ultra-modern way to go, it always seemed to be the boldest in buying across industry lines, targeting the largest companies, and having the biggest batch of ice-breaking deals on the fire at any given time. At its zenith, ITT, from its base as a stagnant operator of overseas telephone companies, had bought its way into electronics, hotels, publishing, lending, insurance, home building, car rentals, industrial products, parking lots, and more. More recently, ITT stood out from the crowd as one of the rare conglomerates that survived in much

the same diversified form as sculpted in the 1960s.

Thus, the ITT break-up virtually closes the book on the conglomerate era as a period of great excess and strategies gone awry. Previous chapters were written with regularity over the last decade and a half. There was Gulf & Western Industries, which boiled its disparate businesses down to Paramount Communications before that entertainment-publishing giant was acquired by Viacom in 1994. There was Litton Industries, which recast its diversification to fit a technology mold. There were Teledyne and Textron, which whittled down their once sprawling portfolios. And there were dozens that overreached and couldn't stick around long enough to restructure.

What went sour? Why are the free-wheeling merger-masters who were lauded as foresighted giants 30 years ago now often reviled as undisciplined gunslingers? How did a strategy so conceptually elegant misfire? In a nutshell, the conglomerates didn't deliver what was promised, and once the bloom was off the rose, they lost credibility — individually and as a group.

Completed Divestitures — 1980 to 1995*

Year	No. of Deals	Value ($ bil)
1980	104	$5.1
1981	476	10.2
1982	508	8.2
1983	733	22.2
1984	800	43.7
1985	767	49.9
1986	1,079	81.5
1987	998	75.3
1988	1,261	105.8
1989	1,610	88.2
1990	1,895	85.9
1991	1,769	57.2
1992	1,666	53.4
1993	1,840	71.6
1994	1,923	118.3
1995 (1st half)	921	65.2

*From 1980 through 1990, totals include deals valued at $1 million or more. From 1991 to the present, only deals valued at $5 million or more are included.

Source: Mergers & Acquisitions magazine

Foreign Acquisitions of U.S. Companies — 1980 to 1995*

Year	No. of Deals	Value ($ bil)
1980	167	$6.8
1981	286	15.4
1982	126	4.2
1983	80	1.7
1984	130	7.9
1985	259	27.9
1986	352	31.3
1987	374	55.5
1988	545	65.9
1989	700	69.6
1990	793	56.4
1991	517	29.2
1992	379	15.7
1993	355	22.1
1994	438	43.2
1995 (1st half)	243	31.2

*From 1980 through 1990, totals include deals valued at $1 million or more. From 1991 to the present, only deals valued at $5 million or more are included.

Source: Mergers & Acquisitions magazine

Conglomerates sprouted as responses to the rigid antitrust enforcement policies of the 1960s. Precluded from acquiring in their own markets, some companies began casting about for other industries that offered higher growth and juicer returns. The early success of the pioneers drew scores of imitators who, by the late 1960s, had dressed up their strategy as contracyclicality, which fast became a code word for hot companies led by geniuses. By blanketing a host of markets, the reasoning went, the company had enough irons to fare well whether the economy was rising or falling.

Execution fell far short of expectations. Some companies strapped themselves with debt in doing acquisitions by the bucketful and were hammered by a rise in interest rates. The skills to manage bewilderingly diverse arrays of businesses were wanting. Many jettisoned the prime tenets of conglomerization — reining in overhead costs and assigning key decisions to operating units closest to the markets — by running up administrative expenses and centralizing authority in the headquarters suite. And contracyclicality didn't work, as the stable performers couldn't offset the drains of recession-battered units during the 1970 economic downturn.

But the ultimate coup de grace was to come later when huge institutional investors began to dominate the stock market and pressed their demands for simpler, more focused companies that eschewed widespread diversification.

The fate of the conglomerates has significant implications for mergers and acquisitions in the later stages of the 30-year period. Before forging the linkage, however, let's segue into another perspective on m&a activity over the last 30 years.

Let's assume that a modern Rip van Winkle went to sleep in 1965 and awoke from a three-decade slumber in 1995. If Rip had scanned the 1965 stock market listings, he would have found such large publicly traded companies as American Standard, Rayonier, Federated Department Stores, Owens-Illinois, Northwest Airlines, Burlington Industries, El Paso Natural Gas, Kaiser Alu-

minum, MGIC, Sunbeam, and Safeway Stores. What would a similar sampling show in 1995? American Standard, Rayonier, Federated Department Stores, Owens-Illinois, Northwest Airlines, Burlington Industries, El Paso Natural Gas, Kaiser Aluminum, MGIC, Sunbeam, and Safeway Stores.

If Rip concluded that nothing had happened in m&a, he would, of course, be dead wrong. For each of those giants had been acquired at some time during the last 30 years before returning to public ownership, usually via a spin-off or IPO.

American Standard, Owens-Illinois, Northwest, Burlington, and Kaiser were among the big firms acquired in jumbo-sized LBOs, another format that surfaced during Rip's slumber, and then taken public again through IPOs. El Paso Natural Gas, Rayonier, and MGIC were strategic acquisitions that later were cut loose when their parents restructured. Federated and Sunbeam outlived acquirers that crashed and burned in the bankruptcy. Scores of smaller companies have followed similar routes from acquisition to restoration of independence, often under the rubric of corporate restructuring.

These various forces — the unwinding of conglomerates, corporate restructuring, reversal of LBOs, and others — underscore a key dynamic of the m&a movement. Deals have constantly been unscrambled for reasons both right and wrong, and who can say that some of the most acclaimed transactions of today won't be sundered if the conditions that impelled them change radically in the future.

But the remarkable element of the entire picture is that in the face of numerous reversals, mergers and acquisitions continue to boom and reach new thresholds in terms of size, ambition, and thrust. At least $1.3 trillion was paid out to do deals in the 1980s.

The count for the first half of the 1990s — which includes a few lean years — has shattered the $900 billion mark at minimum, with the first half of 1995 adding $166 billion to project perhaps the biggest year in m&a history for both deals and dollar volume and already push total confirmed values past the trillion-dollar plateau. And while the frenetic 1980s generated 23,441 m&a completions, a total of 20,430 was logged in the 1990-1994 period, followed by at least another 2,524 in the first half of 1995. If any semblance of the recent pace continues, the much-fabled 1980s will become the runner-up among the decades of great dealmaking.

Plenty of other heavyweight deals are brewing at this writing to both enlarge the numbers and affirm the quality of m&a trends as the 21st Century draws near. Walt Disney Co. is acquiring Capital Cities/ABC Inc. in a $19 billion deal that will rank as the second-largest in history. Westinghouse Electric Corp. agreed to ante up $5.4 billion to buy CBS Inc. Kimberly-Clark Corp. and Scott Paper Co. are merging in a $7.4 billion transaction. Hoechst AG is wrapping up its acquisition of Marion Merrell Dow for $7.1 billion. Scads of big mergers linking major players in banking, insurance, communications, information systems, defense, retailing, and industrial products are being hammered out.

The incredibly broad sweep of mid-1990s dealmaking — big, small, and the vast mid-sized market between the two flanks, strategic as well as financial acquisitions, cross-border as well as in-country transactions — signals the 30-year graduation of m&a from a fuzzily conceived, opportunistic afterthought to a highly disciplined, finely tuned initiative at the front ranks of business development. In its present guise, m&a is frequently the preferred alternative to licking problems, obtaining speedily the resources needed to respond to myriad forces impacting the conduct of modern business, and positioning a company to withstand the rigors of future competition.

Completed Deals — 1965 to 1995*

Year	No. of Deals**	Year	No. of Deals**
1965	1,893	1981	2,328
1966	1,746	1982	1,617
1967	1,354	1983	2,087
1968	1,829	1984	2,255
1969	1,712	1985	1,731
1970	1,318	1986	2,523
1971	1,269	1987	2,517
1972	1,263	1988	3,015
1973	1,064	1989	3,810
1974	926	1990	4,297
1975	981	1991	3,536
1976	1,145	1992	3,719
1977	1,209	1993	4,081
1978	1,452	1994	4,797
1979	1,531	1995 (1st half)	2,524
1980	1,558		

*From 1965 through 1990, totals include deals valued at $1 million or more. From 1991 to the present, only deals valued at $5 million or more are included.

**Divestitures and LBOs are included in the totals.

Source: Mergers & Acquisitions magazine

If new technologies are rapidly opening new markets or threatening existing ones, m&a can capture the benefits, e.g., AT&T Corp. and McCaw Cellular Communications Inc.; International Business Machines Corp. and Lotus Corp. If economic or political developments are forcing industry consolidations, m&a can be leveraged to obtain mass, scale or diversity, e.g., Lockheed Corp. and Martin Marietta Corp. in defense; Columbia/HCA's mega-acquisitions in hospitals; the parade of banking mergers executed by such ever-expanding institutions as BankAmerica Corp., NationsBank Corp., and Banc One Corp. If poolings of skills and resources are essential to accelerating technical breakthroughs, m&a can effect quick combinations, e.g., American Home Products Corp. and American Cyanamid Co., in pharmaceuticals. If industries are globalizing, m&a can help key players spread out ahead of the pack, e.g., Grand Metropolitan PLC and Pet Inc., in food; Crown Cork & Seal Co. and Carnaud Metalbox SA, in packaging.

Mergers, acquisitions, and the divestiture variation have been applied in an infinite number of other scenarios — when companies must sell because they've reached the limits of their capacity to finance growth; when companies are trying to jump-start top-line growth after restructuring; when private-company owners want to retire; when competition enters a hitherto monopoly industry, such as utilities; when diversified companies want to narrow their core operations; when customer markets are reshaped, and demanding bigger suppliers, e.g., the emergence of category killer retailers.

The mergers and acquisitions solution did not enjoy

Largest Completed U.S. Deals of All Time

Acquirer	Target	Target Industry	Value ($ bil)	Date
Kohlberg Kravis Roberts & Co.	RJR Nabisco Inc.	Food, tobacco	$24.72	4/89
AT&T Corp.	McCaw Cellular Communications Inc.	Telecommunications	18.92	9/94
Chevron Corp.	Gulf Corp.	Oil and gas	13.30	6/84
Philip Morris Cos. Inc.	Kraft Inc.	Food	12.64	12/88
Time Inc.	Warner Communications Inc.	Motion pictures, recordings	12.64	1/90
Bristol-Myers Co.	Squibb Corp.	Pharmaceuticals	12.53	10/89
Texaco Inc.	Getty Oil Co.	Oil and gas	10.13	2/84
Merger Partners: Martin Marietta Corp. and Lockheed Martin Corp.		Aerospace, defense	10.00	3/95
Viacom Inc.	Paramount Communications Inc.	Motion pictures, publishing	9.60	7/94
American Home Products Corp.	American Cyanamid Co.	Pharmaceuticals	9.56	12/94
Beecham Group PLC	SmithKline Beckman Corp.	Pharmaceuticals	8.28	7/89
Viacom Inc.	Blockbuster Entertainment Corp.	Video rentals, music retailing	7.97	9/94
British Petroleum Co. PLC	Standard Oil Co. (remaining 45%)	Oil and gas	7.56	6/87
AT&T Corp.	NCR Corp.	Computers	7.53	9/91
Dow Chemical Co.	Marion Laboratories Inc. (67%)	Pharmaceuticals	7.08	12/89
Du Pont Co.	Conoco Inc.	Oil and gas	6.92	9/81
Matsushita Electric Industrial Co.	MCA Inc.	Motion pictures	6.89	1/91
GTE Corp.	Contel Corp.	Telecommunications	6.75	3/91
Campeau Corp.	Federated Department Stores Inc.	Department stores	6.51	7/88

such an exalted status for all of the last 30 years. The path to eminence was checkered. There was, for example, no encore to the conglomerate blitz, and much of the 1970s was a dealmaking wasteland, at least on the basis of more recent benchmarks.

At least part of the blame is traceable to the bad taste left by the conglomerate binge. Although conglomerates had yet to fully fall from grace by the early 1970s, mainstream corporate managers were turned off by the way in which their deals were done. Retrospectively, it became obvious that many transactions were haphazard affairs put together almost overnight with cursory investigation, a handful of quantitative calculations, few follow-up plans for wringing value from the deals, and a paucity of outside advisory skills. This did not sit well with a generation of executives reared in a tradition that acquisitions were high-risk gambles and that corporate macho was pegged to internal growth and getting the best performance out of existing assets. But even those who saw value in doing acquisitions right were hamstrung by dire economic conditions created by repeated shocks from the Arab oil embargo, roaring inflation, sky-high interest rates, a limping stock market, and general malaise across the economy.

Not that the 1970s didn't record some memorable m&a milestones. It was the period in which the hostile acquisition by corporate buyers — increasingly common today — took its present form, led by such transactions as the INCO Inc. purchase of ESB Inc. and United Technologies Corp.'s acquisition of Carrier Corp. There was also a burst of dealmaking by large oil companies seeking diversification in the hopes of surviving the dwindling of reserves. Their initiatives led to some of the most unproductive acquisitions in history —

Largest Completed U.S. Deals of All Time
(continued)

Acquirer	Target	Target Industry	Value ($ bil)	Date
Kohlberg Kravis Roberts & Co.	Beatrice Cos. Inc.	Food	$6.25	4/86
Merck & Co.	Medco Containment Services Inc.	Pharmaceutical benefits management	6.23	11/93
U.S. Steel Corp.	Marathon Oil Co.	Oil and gas	6.15	3/82
General Electric Co.	RCA Corp.	Electronics, broadcasting	6.14	6/86
Grand Metropolitan PLC	Pillsbury Co.	Food	5.76	1/89
Seagram Co. Ltd.	Matsushita Electric Industrial Co. (80% of MCA Inc.)	Motion pictures	5.70	6/95
Mobil Corp.	Superior Oil Co.	Oil and gas	5.70	9/84
Royal Dutch/Shell Group	Shell Oil Co. (remaining 30.5%)	Oil and gas	5.67	6/85
Columbia Healthcare Corp.	HCA-Hospital Corp. of America	Hospitals	5.60	2/94
Kohlberg Kravis Roberts & Co.	Safeway Stores Inc.	Supermarkets	5.36	11/86
Roche Holding AG	Syntex Corp.	Pharmaceuticals	5.30	11/94
Southwestern Bell Corp.	Cie. Generale des Eaux	Cellular communications	5.29	
Columbia/HCA Healthcare Corp.	HealthTrust Inc.-The Hospital Co.	Hospitals	5.22	4/95
B.A.T Industries PLC	Farmers Group Inc.	Insurance	5.17	12/88
Eastman Kodak Co.	Sterling Drug Inc.	Pharmaceuticals	5.10	2/88
R.J. Reynolds Industries Inc.	Nabisco Brands Inc.	Food	4.90	9/85

Source: *Mergers & Acquisitions* magazine

Exxon Corp. and Reliance Electric, Mobil Corp. and Montgomery Ward, Atlantic Richfield Co. and Anaconda — and by today most of the oil giants that tried go far afield have reverted to their traditional forms.

By the late 1970s, there was actually a modest dealmaking revival that proved to be the spark plug for the next decade. It was not driven by straight-up mergers and acquisitions but by the advent of corporate restructuring. After a bitter decade of economic battering, large companies — conglomerates as well as less diversified multi-market operatives — recognized that the forces of change unleashed during the 1970s would intensify and they could not survive by clinging to a plethora of businesses with varying needs and prospects. Therefore, they began to divest, selling businesses that offered little growth potential, diverged too much from their chosen cores, had voracious appetites for capital, or were just too small to keep. They found willing buyers in companies that could make optimal use of someone else's excess baggage, but many sell-offs were done through management and leveraged buyouts on an unprecedented scale. That thrust the LBO into the big leagues and set the stage for the massive financial deals that spiced the m&a market in the 1980s, culminating with the Kohlberg Kravis Roberts & Co. $24.7 billion takeover of RJR Nabisco Inc. which still ranks as the highest-priced deal of all time.

The Confluence of Tides

At the start of the 1980s, everything came together for the m&a market. On the corporate side, companies sobered by the jolts of the 1970s put a premium on strategic planning, market intelligence, and long-range preparation, discovering in the process that acquisitions could work for them and that a market had formed for divesting their unwanted operations. Harsh experiences became teaching models that demonstrated the right way and the wrong way to acquire. Systematic methods of pricing, valuation, negotiating, financial engineering, and integrating acquisitions were refined.

Financial buyers, armed with war chests supplied by investors and lenders, executed a stream of continually larger transactions. Foreign companies prompted by globalization hit North America in droves. Well-heeled financial raiders bent on breaking up companies or merely putting them into play joined the buy-side with full force.

The environment, moreover, was rife with favorable factors. Money to do deals was plentiful. Antitrust enforcement was relaxed. Institutionalization of the stock market represented a pressure for targets presented with tempting acquisition bids. A highly skilled service infrastructure of investment bankers, lawyers, tax experts, due diligence probers, valuation mavens, and even environmental specialists developed to skipper buying and selling through the gritty m&a process. Shareholder value motivations leaped to the forefront, triggering both acquisitions and sell-offs.

There seemed to be a deal to fit every purpose. When the oil companies needed more reserves, they bought the resources in big-ticket acquisitions, e.g., Chevron Corp.'s $13.3 billion acquisition of Gulf Corp. and Texaco Inc.'s purchase of Getty Oil Co. for $10.1 billion. When cigarette makers worried about an eroding market, they diversified, e.g., Philip Morris Cos. Inc.'s acquisitions of Kraft Corp. for $12.6 billion and General Foods Corp. for $5.6 billion. When also-rans needed heft to battle an industry front-runner, they combined, e.g., the $4.4 billion merger of Burroughs Corp. and Sperry Corp., in computers. When technology was needed, it could be acquired, e.g., General Electric Co.'s $6.1 billion purchase of RCA Corp.

There were highly creative deals that pushed the bounds of financial engineering and plain vanilla cash purchases, white-knight buyers to rescue besieged targets from unwanted bidders, LBO acquisitions to take over and restructure companies with limp stock prices, huge divestitures to press restructuring projects.

Despite the decrying of the excesses and the obsessiveness of the 1980s — and there are an uncomfortable number of instances — the developments of that era generally have boded well for the current decade. It was a period in which m&a techniques were refined, skills honed, business plans sharpened, and a formalized market based on demand and supply of buyers and sellers established. Unlike the conglomerateurs, the dealmakers of the 1980s have passed on a worthy inheritance. That is why dealmaking has snapped back so smartly from an early 1990s dry spell caused by a sagging economy and restraints on capital.

As much as m&a technology advances, however, it is important to recall that the mergers and acquisitions process, for all of its systemization, is basically an art grounded in science.

The economic, technological, regulatory, political, capital markets, and other forces that have stimulated m&a demand will continue to evolve ceaselessly, perhaps upsetting the strategies and rationales underpinning many transactions of today. Some best-guess projected trends, such as technological convergences, cost-saving synergies, efficiencies of scale, and market expansions, may never pan out. The jury is still out on many headline deals of the past, and the best of today's cluster may have to be taken apart tomorrow. ■

Highest Priced Deals of Each Year — 1965 to 1995

Year	Acquirer	Target	Target Industry	Value ($ bil)
1965	Union Oil of California	Pure Oil	Oil and gas	$0.66
1966	Atlantic Refining	Richfield Oil	Oil and gas	0.54
1967	Diamond Alkali	Shamrock Oil & Gas	Oil and gas	0.29
1968	Occidental Petroleum	Hooker Chemical	Chemicals	0.48
1969	Xerox Corp.	Scientific Data Systems	Computers	0.91
1970	ITT Corp.	Hartford Fire	Insurance	1.80
1971	Schering Corp.	Plough Inc.	Pharmaceuticals	0.48
1972	Colgate-Palmolive	Kendall Co.	Medical supplies	0.53
1973	Norton Simon	Max Factor	Cosmetics	0.48
1974	Tenneco	La Terre Co.	Natural resources	0.27
1975	Standard Oil of California	Amax Inc.	Natural resources	0.33
1976	General Electric Co.	Utah International	Construction	2.17
1977	Du Pont Co.	Christiana Securities	Holding company	1.57
1978	Johns-Manville	Olinkraft Corp.	Paper products	0.59
1979	Shell Oil Co.	Belridge Oil	Oil and gas	3.65
1980	Sun Co.	Texas Pacific Oil	Oil and gas	2.30
1981	Du Pont Co.	Conoco Inc.	Oil and gas	6.92
1982	U.S. Steel Corp.	Marathon Oil Co.	Oil and gas	6.15
1983	Santa Fe Industries	Southern Pacific	Railroads	2.30
1984	Chevron Corp.	Gulf Corp.	Oil and gas	13.30
1985	Royal Dutch/Shell Group	Shell Oil (remaining 30.5%)	Oil and gas	5.67
1986	Kohlberg Kravis Roberts & Co.	Beatrice Cos. Inc.	Food	6.25
1987	British Petroleum Co. PLC	Standard Oil Co. (remaining 45%)	Oil and gas	7.56
1988	Philip Morris Cos. Inc.	Kraft Inc.	Food	12.64
1989	Kohlberg Kravis Roberts & Co.	RJR Nabisco Inc.	Food, tobacco	24.72
1990	Time Inc.	Warner Communications Inc.	Movies, recordings	12.64
1991	AT&T Corp.	NCR Corp.	Computers	7.53
1992	BankAmerica Corp.	Security Pacific Corp.	Banking	4.21
1993	Merck & Co.	Medco Containment Services Inc.	Pharmaceutical benefits management	6.23
1994	AT&T Corp.	McCaw Cellular Communications Inc.	Telecommunications	18.92
1995 (1st half)	Merger Partners: Lockheed Corp. and Martin Marietta Corp.		Aerospace, defense	10.00

Source: Mergers & Acquisitions magazine

5

Timely Acquisitions For Survival In Hostile Markets

Donald V. Potter

When competition in the marketplace reaches the boiling point, acquisitions can help key players fight back.

When the words "hostile" and "acquisition" appear together in the same sentence, the subject is usually hostile takeovers. A great deal has been written in recent years about unfriendly acquisitions. Windermere Associates, however, uses the words differently, suggesting a different relationship. Our concern is not with hostile takeovers per se but with hostile markets — markets in which the competition is so intense for so long that few players will survive. Under those conditions, acquisition can be a valuable strategic move if a company can act at the right time to take over the right competitor.

A hostile market or industry is one in which too many competitors are pursuing too little customer volume. Hostility can begin when demand declines. But in about three-quarters of markets the cause is an expansion of competition. The problem, then, is usually too many players.

The symptom of a hostile market is low returns. Average return on equity in a hostile industry is below 8% or 9%, and earnings before interest and taxes (EBIT) as a percentage of total capital employed is below 13% or 14%.

Hostility is common. Nearly every industry experiences hostile conditions at some time, and often at recurring intervals. Industries that have been hostile at some time in the last few years include air express, airlines, beer, cement, computers, copiers, lodging, machine tools, steel, tires, table wine, and trucking.

Donald V. Potter *is President of Windermere Associates Inc., a San Francisco consulting firm specializing in advising businesses on surviving hostile markets.*

THE UPPER HAND

Traditionally fierce competition is intensifying as too many players scrap for too little business. Prices are falling and returns are sliding. Products are proliferating and cost-cutting is rampant.

If your company and your competitors are suffering from these symptoms, you are operating in a hostile market. And the chances are that hostility is no short-term aberration but a long-term, deep-seated condition.

Strategic acquisitions that consolidate the industry, i.e., reduce the number of competitors, can be a way out for the survivors. But acquisition alone is not a sure-fire guarantee. The targets must offer increased share, by adding the "right" customers to the buyer's base, and reduced unit costs that can be accomplished without sacrificing customer service.

Hostility is also a long-term problem. When the industry becomes hostile it usually stays that way for 15 years or more. The airline industry, for example, was deregulated 16 years ago, and the end of its hostility is nowhere in sight. Hostility truly ends only when an industry has passed through all five of its inevitable stages.

Before a market becomes hostile, it is usually dominated by a few confident market leaders who have been raising prices faster than costs and inflation have climbed. Real price increases over five years or more generally encourage the entrance of new competitors who somehow can unbundle the product or offer an acceptable alternative at a lower price. The new entrant begins taking share, but market leaders resist dropping their prices to compete. These leaders reason that their established position and strong brand franchise will keep customers loyal, and that only weaker players will lose share to the upstarts. Eventually, though, enough share shifts so that even the market leaders find their position eroding, and they must drop their prices to compete.

When Compaq Computer Corp. finally dropped its prices, for example, the computer industry became hostile. Once the market price collapses, hostility has begun.

Stage One: Margin Squeeze

Customers — the largest customers, in particular — realize that they can demand and get price discounts of 15%, 20%, and even 25% off standard industry pricing. No supplier can resist these demands for discounts because customers can and will leave. As a result, discounts are matched across the industry and everyone's margin suffers.

Stage Two: Product Proliferation

At this point customers are volatile, meaning that they are willing to switch suppliers if a better option is available. Since prices are already low, however, there is little chance left to gain share by cutting price. Suppliers scramble to find other ways to compete, and that is by offering product variations — either unbundling the product to offer a lower price on one part of the product offering or adding benefits to the product to make it more attractive at the current price. Product proliferation rarely moves much share, though, because competitors' initiatives usually can be copied quickly across the industry.

Stage Three: Self-Defeating Cost Reduction

Desperate to keep viable margins, companies chop fat and, eventually, flesh. Many cost reduction efforts are ultimately self-defeating because they result in lower standards of customer service. Once customers can see the cuts — once they realize, for example, that quality has slipped, response time is slower, or there are fewer people to help them — they have yet another reason to leave. As a practical matter, costs almost never come down as fast as share falls when costs are reduced at the expense of the customer.

Stage Four: Consolidation and Shake-Out

Some competitors simply leave the market; others are acquired by stronger companies. And typically these companies reduce the cost of their overhead, by combining their staffs and operations (which may mean layoffs) and by spreading the remaining overhead over a larger base of sales. The result of consolidation and shake-out is a smaller number of competitors but even tougher competition, because the survivors at this point are larger, leaner, and meaner.

The Final Stage: Rescue

Hostility does eventually end, although not always when competitors believe it has. A hostile market sometimes will achieve a temporary respite lasting perhaps 18 months to three years. There may be an unexpected surge in demand. Or political or economic changes may alter global competition. For example, in 1987 a devaluation of the dollar made domestic steel more competitive versus European or Asian steel, and immediately American steel production went from 65 million to 78 million tons a year.

Long-term, permanent relief — that is, rescue —

occurs when just three or four competitors, in control of about 85% of the industry, are satisfied with their market share and decide not to discount prices in order to gain more business.

Acquisition as a Strategic Move

When and how can acquisitions be part of a company's strategy for surviving market hostility? The answer is that the right acquisition can help meet two objectives:

- Gaining share and
- Reducing unit costs.

Gaining Share and Customers

One of the ironies of market hostility is that, while hostility makes customers more demanding and more ready and willing to change suppliers, share shift actually decreases once hostility begins. In fact, the greatest period of share shift takes place just at the onset of hostility when new entrants are luring customers with different offerings and lower prices while market leaders refuse to play the game.

Once market leaders begin responding, and matching others' competitive moves, customers can get what they want from their current suppliers. Despite threats, few customers actually move unless their current supplier somehow "fails" them by not keeping pace with competitors.

Once hostility begins, then, share is extraordinarily difficult to gain. It may have to be bought.

What, though, is it important to acquire? Not cash flow or assets, which are largely irrelevant in the hostile market environment. The purpose of acquisition is to gain new customers, to add share. Market share does count, especially in times of hostility.

Conventional wisdom holds that greater sales volume helps a company move down the learning curve and reduce its costs. This is true. But market share counts for another reason. All things being equal, customers tend to stay in existing relationships. Luring away competitors' customers can be expensive under the best of conditions and almost impossible once market hostility sets in. For the same reasons, though, keeping one's own customers should be quite feasible. The challenge is in getting additional customers. In a hostile market, acquisition is often the least expensive—indeed, maybe the only — way to gain share.

For an acquisition to be beneficial, though, the right customers need to be acquired. The acquired company's customer base must meet two criteria:

- Loyalty and
- Substantial net addition.

The Target's Customers Must Be Loyal

The acquisition will be pointless if customers slip away like sand between your fingers. Customers have to be sufficiently committed to the supplier that is acquired so that they will stay after the acquisition.

Some companies, by the nature of their business, have disloyal customers. These companies are often price-shavers who have habitually offered prices 2% to 3% off industry standard, and they gain or lose share with a certain fickle buying segment depending on their prices at the moment. Other companies have weakened customer loyalty by eroding their brand franchises.

In the appliance industry, Admiral Corp. offers an example of an unwise acquisition. As this industry consolidated over the last 20 years, Admiral, noted mainly for refrigerators, was bought by Magic Chef Inc., whose primary offerings are stoves and ranges. By the time Admiral was acquired, however, its name had been run down and it no longer brought Magic Chef a loyal base of customers in what for the buyer was a new segment of the appliance market. Eventually, Magic Chef itself was bought up by Maytag Corp. in 1986 in a further consolidation of the market.

Costs almost never come down as fast as share falls when costs are reduced at the expense of the customer.

A more successful example can be found in the glass container industry. Owens-Illinois Inc.'s long-time role as industry leader had been in jeopardy until, in 1986, it acquired a smaller competitor, Brockway Glasss Co. As a result of the acquisition, Owens Illinois' market share jumped from 27% to 41%.

A Substantial Net Addition

In acquisitions, one plus one doesn't necessarily make two. Stated differently, it isn't always possible for the acquiring company to hold all of the volume that it formerly got from a customer plus all of the volume that the acquired supplier formerly enjoyed.

Why not? Because customers generally do not want to place too much of their volume with a single supplier. Most customers, in fact, have three categories of suppliers, each filling a different role.

The primary supplier usually accounts for most of the customer's purchases. But the customer also will

have a relationship with a secondary supplier, giving that supplier enough volume to maintain the relationship so that the customer can maintain leverage with the primary supplier and take out insurance against any supply problems. A tertiary supplier also may get business from time to time to meet peak demands, to provide additional insurance and leverage, or to supply a special product need.

The key to knowing how much net new volume an acquisition can add is to look for overlaps in client relationships or roles. If the acquiring company and the target serve the same customers in the same or even in different roles — for example, one is the primary supplier and the other the secondary supplier — combining these competitors may result in some share loss for the merged company. Most likely the customer will give some of that business to another supplier, perhaps even a new supplier, for its own protection.

Owens-Illinois' acquisition of Brockway shows the dynamics of overlap. After the acquisition, Owens-Illinois' share went up to 41%, but in the next four years it dropped slightly to 40%. The two companies had served some of the same customers. Where there was overlap, the very large companies that had several suppliers were willing to consolidate the OI- Brockway volume. But smaller companies for whom either Owens-Illinois or Brockway had been the primary supplier then added another supplier that took some of the volume.

Reducing Unit Costs

Market hostility also increases the importance of reducing costs, which becomes especially important in the latter stages of hostility. The challenge, as we have seen, is to reduce costs without eroding quality or service, which are visible to customers.

Acquisitions can be the key to reducing costs because the combined companies usually can reduce their overhead and then, assuming that the customers of the acquired company are loyal, spread their costs over a larger customer base, resulting in lower unit costs.

Two examples illustrate the cost-reduction potential of acquisitions in a hostile market.

Anchor Glass Container Corp. is now the No. 2 competitor in the glass container industry. But it wasn't always so. Anchor took shape in 1983 by acquiring the glass container division of the former Anchor Hocking Corp., and added Midland Glass Co. in 1984 and Diamond-Bathurst Inc. in 1987. While adding customers, Anchor rigorously cut overhead costs. Midland's overhead was cut by a whopping 80%. Overall, Anchor reduced its sales, general, and administrative expenses as a percent of revenues from 11% in 1982 to only 3% in 1988.

Delta Air Lines Inc.'s rise to become the No. 3 domestic airline got a big boost when it acquired Western Air Lines Inc. in 1986. The acquisition gave Delta additional ties to the West Coast, including a hub in Salt Lake City and service to 44 additional cities, and allowed it to consolidate its one western hub, in Los Angeles, with Western's. As part of the deal, Delta brought Western's salaries up to its own higher levels, raising its total cost for salaries and related expenses by 14%. But this cost was offset by a 20% increase in sales. As a result, Delta's unit cost structure fell notably through the acquisition.

When a market becomes hostile, bigger is nearly always better. Larger companies usually are better positioned to survive the long period of intense competition because they have a larger customer base across which to spread costs, and therefore a lower cost position. As hostility approaches, and especially once it begins, however, the only way for a company to become bigger quickly is likely to be by acquiring competitors and securing their market shares. A well-planned acquisition can be the strategic move that ensures eventual prosperity. ■

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WHARTON REPROGRAPHICS 6

General Cinema Corporation (A)

*Professor **Hugo Uyterhoeven** adapted this case from the original case written by Assistant Professor **Robert W. Ackerman** to serve as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.*

"At General Cinema we believe that our company's growth and earning power is recession resistant and inflation immune," stated Richard A. Smith, president, in September 1975. "We had a record year in 1974 despite rampant inflation. This year our results will be considerably better during the most severe recession since the early 1930s. General Cinema's business, although not providing necessities, does bring relatively inexpensive pleasure and satisfaction to the public. It operates from a protected base of exclusivity through unique locations in regional shopping centers or exclusive and perpetual beverage franchises. This position gives us the confidence to project continuing earnings growth in the years to come. Our objective is to increase earnings at an annual rate of 15–20%."

General Cinema's previous growth had been impressive. Revenues had risen from $8.1 million in 1960 to $358.4 million in 1975, and earnings had increased from $870,000 to $14.9 million. Earnings growth, interrupted only once during the tremendous interest rate escalation in 1973, had been at a 23.4% compounded rate over the previous 10 years, providing a 20% return on equity. In 1976, General Cinema, with 9,600 employees, was the largest theater chain in the United States and the largest independent bottler of both Pepsi-Cola and Dr Pepper products, as well as the largest U.S. soft drink bottling company, having passed Coca-Cola Bottling Company of New York in 1975. (See *Exhibits 1* and *2* for income statements and balance sheets.)

Company History

General Cinema was an outgrowth of a company organized in 1922 by Philip Smith to build and operate movie theaters. In 1935 Smith was credited with constructing and opening the first successful open-air theater. Although the company remained small, it nonetheless was one of the largest and most successful newcomers to the open-air segment of the industry in the years before World War II.

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Richard Smith, who became president in 1961 upon his father's death, commented on the post–World War II years:

> While the rest of the industry enjoyed great prosperity during the war, we just barely survived the effects of gas rationing and daylight savings time. After the war, however, the situation was reversed. Television was devastating to the indoor theater operator, and the large chains were beset with legal problems. On the other hand, we found that we attracted a different kind of audience—families and young people—and benefited from laws which lowered driving ages, just as downtown theaters were penalized by inadequate parking facilities. This company was among the first to lengthen the playing season by introducing heaters to keep cars warm in the wintertime. Desirable land parcels of 25 to 35 acres were available in those days, close to population centers at reasonable prices, and we expanded by building modern facilities equipped with playgrounds and amusement areas. As our position improved, we began competing for first-run movies.

The postwar period had been dismal for the theater exhibition industry. Competition from television, population shifts to the suburbs, the growth of alternative leisure activities, and a decline in the number of feature films from more than 400 to between 200 and 250 had all contributed to a decline in both industry revenues and the number of theaters. The latter had dropped from 18,631 in 1948 to 16,354 in 1958, while admissions receipts had shrunk from $1.7 billion in 1946 to $1 billion in 1958. As a result, movie exhibition receipts declined from 19.8% of U.S. recreational expenditures to 6.3% during the same period.

Also of importance to the industry were the consent decrees that the Justice Department had secured from the "Big Five" (Paramount, Twentieth-Century Fox, Warner Brothers, Loew's, and RKO) in 1949 and 1952, after a decade of litigation. As a result, each picture was to be rented on a picture-by-picture, theater-by-theater basis; each existing company was to be divided into a theater-exhibition and a production-distribution company; and certain theaters were to be divested. Divestitures under the consent decree amounted to about 1,200 theaters and contributed significantly to the drop in the number of theaters held by the Big Five—from 2,765 in 1948 to 1,223 in 1958.

Up to that time, the Big Five had been vertically integrated, each firm possessing production, distribution, and exhibition facilities. They had dominated the motion picture industry, releasing approximately 80% of all feature films and a significantly higher percentage of box office successes. Although the Big Five controlled only 17% of the nation's theaters in 1945, they accounted for 45% of domestic film rentals. In particular, they were the dominant factor in downtown theater districts, as they operated more than 70% of the first-run movie houses in cities with populations exceeding 100,000. As much as 80% of the profits reported by integrated companies were thought to come from the exhibition activities.

In contrast to the decline in indoor theaters, from 17,811 in 1948 to 14,714 in 1954, drive-ins had increased from 820 to 3,775 during the same period. In line with this favorable trend, Midwest Drive-In (the name was changed to General Cinema in 1964) had prospered; by 1959 it was one of the three largest competitors in this segment of the industry. However, as the availability of land declined and land values increased sharply, new locations became difficult to secure and the company's growth leveled off in the late 1950s at about $5.5 million in sales and $600,000 in after-tax profits.

In 1960 Midwest Drive-In acquired the Smith Theater Company (1959 sales of $2.1 million and profits of $136,000), owner of 14 indoor theaters in suburban and resort locations and of one drive-in. Both companies were controlled by two families[1] and managed by the Smith Management Company.[2] The combined company then went public with a $2.25 million, 180,000-share offering,[3] with the proceeds from 130,000 shares accruing to certain selling shareholders and the remainder to the company. The company planned to use its proceeds for the expansion of shopping center theaters and diversification into tenpins bowling.

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1. Before the public offering, the Smith family owned or controlled 45.3% and the Stoneman family 25.4% of the outstanding stock of the combined companies. These amounts were reduced to 34.9% and 20.0% following the offering. Richard Smith was not among the selling shareholders. In 1976 these percentages were approximately 25.1% and 12.4%, the reduction due largely to a secondary issue in 1968.
2. It was common in the theater industry for individual theaters to be operated by a management company in return for a management fee.
3. The stock was sold at $12.50 per share, a price equivalent to $2.42 in 1976 shares.

Among the properties acquired with the Smith Theater Company was a theater in the Framingham (Massachusetts) Shopping Center. The shopping center, thought to be the first of its kind in the United States, had caught Philip Smith's imagination in 1951, and the promoter persuaded him to put a theater in it. Initially the theater lost money, and the shopping center itself experienced periodic financial difficulties for over a decade. By 1959, however, admission receipts were twice the initial level, and the shopping center theater was contributing the largest profits in the theater group by a wide margin. A second shopping center theater had been acquired in 1955, at which time there were, according to management, about four such shopping center theaters in the entire country.

In the late 1950s, Richard Smith, who had assumed responsibility for developing new theater locations, noticed that the number of shopping centers under consideration was increasing rapidly. However, he found that promoters whom he asked to invest the $300,000 required for a 1,200-seat theater were reluctant to take such a risk in a troubled industry in conjunction with a small private company. The 1960 merger and public offering were conceived to ease the financial impediments to growth.

The company prospectus also indicated that the company planned to enter the tenpins bowling business through the immediate construction of three bowling centers in New England with a total of 104 lanes. It noted: "After the company has had the benefit of its experience in this area, it may expand its original goal of 300 to 400 lanes and undertake the establishment of bowling alleys . . . in metropolitan areas outside of New England." Management intended to proceed in bowling as it had in open-air theaters. Centers were to be "first-class," complete with restaurants and lounges and geared for use by families and young people. Tenpins bowling was enjoying a rapid rise in popularity in the United States in all parts of the country except the Northeast, which had traditionally been a stronghold of candlepin bowling. According to the American Bowling Congress, the number of tenpins lanes increased 87% from 1955 to 1960, and individual memberships in the congress jumped 111%.

The management group considered bowling to be a particularly appropriate opportunity for the company; it was a leisure-time business thought to appeal to the type of person who enjoyed an evening at the movies. In addition, automatic pinsetters appeared to make tenpins bowling the most attractive variety of the sport for the participant. Moreover, the company was experienced in securing sites, constructing facilities, and managing a multiple-location business. In some respects growth in bowling seemed easier to attain than growth in theaters; locations were not so difficult to find, since they were not tied to shopping centers, and credit and marketing assistance were readily available from AMF and Brunswick Corporation, the dominant pinsetter manufacturers.

Theater Operations

Industry Trends

From a nadir in 1962, the movie exhibition business staged a comeback, reflected in the statistics in *Exhibits 3* and *4*. Total receipts were increasing at 5% to 6% a year in the late 1960s, although attendance continued to decline. Shopping center and suburban theater attendance increased; and the traditional 2,000- to 3,000-seat downtown "movie palace" continued to lose audiences. As new suburban and shopping center theaters began to attract a greater share of movie audiences and were often able to command higher ticket prices, they broke the dominance of downtown theaters in securing first-run movies.

Other changes occurring in the industry during the 1960s were described by Smith in a speech in 1970:

> The myth of the fifties that movies catered primarily to a limited, declining, nonsophisticated segment of the population has been exploded in the sixties by the success of multiple-auditorium theater complexes simultaneously offering up to eight different films with the widest variety of audience appeal. Areas that only a few years ago were considered marginal for a satisfactory return on the investment required for a single theater now are capable of supporting a multiple-auditorium complex. The most fundamental change in the sixties has been in the audience profile. Today's audiences are, for the most part, younger, better educated, more affluent—many from the academic community and more of the "white-collar" rather than "blue-collar" group. They are critical, involved in the issues of the day,

and shun the make-believe world that used to pass for "real life" in the movies that enchanted millions a mere 10 or 15 years ago.

By the mid-1970s, Smith was even more optimistic. The 1974 annual report commented: "A marked change in movie fare away from the message, social problem, and sex films of the recent past to the pure entertainment and sometimes nostalgic films of today broadened the base of appeal beyond the youth group which had predominated in the makeup of the movie audience. Now it includes virtually every age and market segment." Smith expanded in a 1975 speech:

> I have been asked many times why I expect theater attendance to continue to rise in spite of its essentially flat behavior all through the sixties. The answer is that in the sixties too many of the filmmakers were on the artistic perimeter of society, making films on controversial subjects or trying to make statements on behalf of political causes sometimes and social causes very often. In the last couple of years they have returned to basics. This is an entertainment medium; we do not approach it primarily as an artistic means of expression.

He stressed that these general-audience "breakout" films had attracted more 25- to 50-year-olds on a regular basis. He said: "It becomes increasingly evident that people don't stop going to the movies as they grow older, even though 52% of the population does not go to the movies at all." Smith expected attendance to increase at a rate of at least 3% over the next few years.

Theater Expansion

By late 1976, General Cinema ran 674 theaters at 328 locations in 37 states. They represented approximately 4% of all theaters in the United States and roughly 9% of the theater industry's revenues. Over 90% of its theaters were located in or near regional shopping centers and were less than 10 years old.

Beginning in 1963, General Cinema had experimented with Cinema I and II theaters—two 500- to 1,000-seat auditoriums under one roof instead of one 1,200- to 1,400-seat auditorium. The test proved successful on several counts. First, there were some operating cost savings in personnel, advertising, and maintenance. Second, the twin auditoriums provided a means of dampening the effect of increasing construction costs while at the same time increasing revenues. The company's investment in a shopping center twin approximated $100,000 to $150,000, as compared with $75,000 to $125,000 for a single auditorium; the average revenue per location was 50% to 80% higher. Although a few auditoriums had been built with as few as 400 seats, the company had not pursued "mini" theaters (less than 300 seats). During the last several years, General Cinema had continuously converted single theaters to twins and twins to triples so that by 1976 multiple theaters dominated, with only 69 single-auditorium theaters remaining, a number of which would also eventually be remodeled.

Location was considered crucial in determining a theater's success. In addition to the market research performed by the leading retailers in a new shopping center, management was particularly concerned about the economics of film procurement. The existence of several first-run theaters in an area could provide the distributor with leverage to drive a harder bargain and the moviegoer with competitive alternatives. Having a reliable knowledge of operating and construction costs, the company worked with the three remaining variables—ticket price, attendance, and film rental fees—to determine whether an opportunity existed for a 20% return on initial investment after taxes. Refreshment revenues were also important. For example, in 1975 they amounted to $28 million, or 40 cents per capita, compared with an average admission price of $2.20. *Exhibit 5* gives a breakdown of the typical cost structure of a chain theater.

General Cinema attempted, through clean, modern facilities and tasteful programming, to create an image of sophisticated entertainment that would attract family interest. It was the largest customer for Walt Disney films in the country. Wintman, executive vice president, touched on the philosophy that guided the division:

> We think we have the best theaters in the business and we don't spare the expense to keep them that way. We build functional, not lavish, theaters. However, once a theater is built, comparatively little reinvestment is needed to maintain it at that level relative to the cash flow it generates. This provides us with a source of funds for expansion.

Two major acquisitions had been made, both departures from the company policy of limiting

theater additions to shopping centers. In 1970, for $5.75 million in cash and notes, General Cinema purchased Mann Theaters, which operated 15 theaters in Minneapolis–St. Paul (13 located downtown) and had revenues of about $5.6 million. Smith explained in 1971:

> We made an exception with Mann's. Minneapolis has done a nice job in resolving its urban problems; the downtown area has a lot of life in it. We had only one theater in Minnesota and had just missed a couple of shopping center deals, which had been upsetting. The Mann Theaters were in good shape and could form the nucleus of a new region. We've since added several shopping center cinemas in the area.

In 1971, the Justice Department filed a civil complaint seeking divestiture of the Mann circuit. Two years later the suit was settled by a consent decree whereby General Cinema agreed to sell nine of the acquired theaters, most of them located in downtown areas.

In 1972 General Cinema acquired 47 theaters from Loew's Corporation for slightly over $16 million. The acquisition provided significant initial entry into the first-run Miami, Phoenix, Albuquerque, and the greater Los Angeles markets, where General Cinema had not previously obtained desirable locations. The company expected to convert about 12 of these theaters to twin operations to enhance their profitability and to dispose of marginal units. One year later, 21 units, most of them neighborhood and downtown theaters, were sold for $6 million. The 1973 annual report stated: "We felt that they could not be operated in the same manner as the shopping center theaters around which we have built our business."

Early in 1973, General Cinema announced its intention of phasing out drive-in theaters by leasing for more profitable commercial development properties it owned in fee, by selling or subleasing leased properties, and by allowing leases to expire. Attendance at drive-ins had begun to decline over the past decade due to a great shortage of family-oriented films—the traditional mainstay of drive-in operations—and to increased competition from new shopping center theaters. By 1975 the number of drive-ins had declined to 21 from a peak of 50 in 1971. They still contributed 2.5% of General Cinema's total theater revenues, but in terms of income they had been operating at a small loss.

A total of $48 million had been invested during the last five years in new or remodeled theaters, according to the 1975 annual report. General Cinema, given the favorable industry outlook, planned to continue expansion at a rate of about 70–80 theaters per year. Smith explained: "We have been selective, turning down each year several times the number of locations actually accepted. Our selectivity will not be compromised just to reach expected growth levels. Indeed, to build 75 new theaters a year we now require only 20 to 25 locations because our average new unit is a three-theater complex." General Cinema management felt that there was still major growth ahead for shopping center theaters in spite of a slowdown in shopping center construction. The greatest opportunities were felt to be in the Sun Belt, because of its population growth and resulting need for additional retail facilities. In 1976 Smith was asked about General Cinema's rationale for building more and more theaters every year. He replied, "Because we still get about a 40% pretax, pre-interest return on each new shopping center theater that we build. When you show me some better place to put my capital, I'll do it."

Competition

Wintman described General Cinema's competitive position as follows:

> Although General Cinema pioneered the shopping center theater concept, it made no attempt to preempt the marketplace. As early as October 1963, the president of General Cinema publicly urged exhibitors to seek locations in suburbia. It was sincerely felt that an influx of new and viable theaters would serve as an inducement to film producers to increase their investments in films. Over the years, local exhibitors expanded into the suburbs of their own marketplaces while national circuits competed for the regional shopping center locations.
>
> The ease of entry served to proliferate competition. Any exhibitor or entrepreneur with acceptable credit had only to furnish the theater facilities leased to him by the shopping center and built to his specifications. An exhibitor desiring further leverage could lease equipment and enter the marketplace at little or no cost.
>
> Most marketplaces today are fairly saturated, and expansion is limited to the relatively few new shopping centers being built, which in most instances will draw upon patronage already attending existing theaters. There exists virtually no market in which

> there is not already a competitive situation, and General Cinema faces strong competition in every one of its markets. Future expansion will of necessity be limited to marketplaces in which existing movie facilities are either old, poorly maintained and operated, or badly located with respect to population growth and highway accessibility. New shopping center theaters in these places could well prove extraordinarily successful.

Competition in the theater exhibition industry took place at the local, not the national, level. Hence, General Cinema's major competitors differed from market to market. In some places local exhibitors would aggressively compete for locations or film rentals, while in others the major pressure came from national chains. However, the dominance of the "Big Five" theater exhibition companies had long since been broken, and their successor companies had evolved differently. Paramount Theaters had merged with the American Broadcasting Company (ABC), contributing $74 million or 7% of its revenues in 1975 through 277 theaters. Stanley Warner and RKO had, after a series of mergers, become part of Cinerama Inc., with over 100 theaters contributing $38.5 million in 1975 revenues. Twentieth-Century Fox's theater company, National General, had diversified ultimately into insurance, making it a desirable merger target for American Financial Corporation, which retained only the insurance portion of the business and sold the theaters to a privately held company. Loew's, whose control had shifted from Metro-Goldwyn-Mayer to the Tish brothers, had diversified into hotels and real estate and had made some major takeovers, including Lorillard and CNA, so that by 1975 its 102 theaters contributed only 1.4% of total revenues.

In addition to competition from other exhibitors, General Cinema was confronted by alternative means of dispensing movies. Since recent box office successes were not generally available to television and inventories of older films were being rapidly depleted, each of the television networks had begun the production of feature-length pictures for original release. Lurking in the background was the prospect of pay TV, which conceivably could offer conventional film distributors competitive rental fees for first-run pictures. A third possibility was the video cassette or disc. The viewer would buy or rent a film on video tape or disc and replay it when convenient on a recorder incorporated in or attached to a TV set.

Back in 1971 Wintman thought that these new sources of competition would not have a serious impact on theater operators:

> The economics of the business work against other means of exhibition. A feature-length picture can be shown on television once or maybe twice during prime time, no matter how good it is, while we can offer guarantees of 10 to 15 weeks for a picture like "Love Story." As a result, television can afford perhaps $500,000 to $600,000 per picture—about the equivalent of a double-length regular hour TV program. That is a million or so less than the cost of a good low-budget film. In fact, we support the networks: the more films produced, the better. If they strike a good one, they may bring it to theaters first, or, if not, we are always interested in less expensive fillers.
>
> Pay TV, on the other hand, could be a problem if a large enough audience could be attracted. However, the public hasn't accepted the pay-TV concept. We also suspect that the moviegoer really wants to get out of the house, especially the woman, to see a show. For this reason, I bet, except for pornography, cassettes won't generate much of a market for recreational films either, though they may be great for educational purposes.

In 1975 Smith reiterated this opinion:

> As happens with each new technological advance in the telecommunications field, a new round of speculation about the future of movie theaters takes place. Currently two such advances, the satellite-linked pay-TV movie service network and the video-disc players, the visual equivalent of the phonograph, are in the news. In spite of these and other remarkable technical advances, nothing major has changed or will change the basic marketing of motion pictures. According to Paul Kagan Associates, a leading authority on pay TV, there are currently 10 million cable subscribers and the number should grow to 20 million by 1980. Their projection contemplates that there might be 3 million pay-TV subscribers by 1980. There is no way that an audience of this size can produce the income necessary to obtain first-run pictures in competition with movie theaters. We are talking

about a small audience overlap in any event, without considering demographic, economic, and geographical limitations. We still feel that free home television, offering a choice from about 50 movies a week, is our principal competition, although supplemental income to film suppliers from pay TV after theatrical exhibition may eventually be a further stimulant for film production.

As to the video-disc players, it is beyond our comprehension how any but the most wealthy 1% or 2% of the population would spend the money to buy a player for more than $500 and then pay $10 to $20 to see a picture on a TV screen perhaps two or three times at the most. This device will have to find its market in something much cheaper than motion picture features or in material suitable for repeated viewing if it is to be economically viable.

Film Procurement

During the early 1960s General Cinema had initially found it difficult to procure first-run movies for its new shopping center theaters. In several instances the company had to "buy its way" into markets by bidding aggressively on top pictures until its reputation had been established in the community and among film distributors. Exhibitors negotiated with film distributors, in competition with other exhibitors, for the right to show films. The terms of these arrangements were influenced not only by competition among exhibitors but even more by the availability of popular films. A product shortage had gradually shifted the bargaining power to the distributors. By the 1970s rentals for the popular films sometimes caused operating losses. Also, terms had stiffened with respect to the number of weeks that a movie had to be shown, the guarantee of a minimum payment by the exhibitor, payment conditions, dates when movies were to be shown (distributors tended to concentrate introductions during the Christmas and summer seasons), and the pressure on exhibitors to take several pictures from the same distributor.

In spite of this shift in bargaining position, film producers found their business to be extremely volatile. For example, by the end of the 1960s, the large old-line production-distribution companies, which continued to dominate film releases, had incurred massive write-offs of $250 million, caused by excessive inventories of high-budget films. This volatility in performance greatly affected the supply of films, which, in turn, influenced the operating results of the exhibitors.

The product supply had become a major concern for General Cinema management. The 1975 annual report stated: "Over the past few years, the number of major new feature films produced has declined. Conversely, as we continue to expand our theater circuit, our requirements for these films are increasing." Not only the supply but also the cost of film rentals concerned management. General Cinema in 1975 was playing 80–85% first-run pictures, as compared with 40–50% in the 1960s. As a result, film rentals had escalated from 35–40% of box office receipts to over 50%, and operating margins had declined somewhat to around the 10% level. Nevertheless, over the previous 15 years, General Cinema theater prices had stayed ahead of cost increases. Even though consumer resistance to ticket price changes had not significantly affected attendance, General Cinema did not aggressively raise its ticket prices. Since 1970 prices had increased an average of 3.7% annually, a significantly lower rate than that of the consumer price index.

To respond to these pressures, General Cinema departed in 1975 from its long-standing policy of not engaging in film production. As Smith stated:

Our strategy to prevent further escalation of film costs and to be in a position to alleviate any future shortage of film product will be to enter the field of film financing for the benefit of established independent film suppliers and independent distributors. We will pay about $75 million in film rentals this year, and a large part is committed before the pictures open in our theaters, in line with current industry practice. By committing to these contracts earlier, they can become bankable collateral to help finance high-quality independent film producers without any significant change in our exposure or any major use of our capital. We are now working on a number of such arrangements and we feel confident that our film supply will be enriched in both quality and quantity as a result of these efforts.

Our film-financing program aims to avoid much of the volatility of production earnings and yet supply a maximum of quality popular films to a product-starved industry. In fiscal 1977 we expect to deliver a program of pictures worth over $30 million with min-

imal financial exposure to General Cinema. In our program we have elected to presell to the U.S. television networks the exhibition rights of our films, following domestic theatrical release. In addition, we have presold foreign distribution rights. This approach cuts down the ultimate rewards on a blockbuster picture but also reduces the risk in that only 30% to 40% of the costs needs to be recovered in the U.S. market to break even. The primary objective of creating an additional supply of product is to benefit our theater division. However, if this venture's profits can meet our requirements in terms of return on capital at risk, we shall consider this as a potential area for diversification.

Soft Drink Bottling Operations

General Cinema's Entry

General Cinema's entry into soft drink bottling operations took place in early 1968 through acquisition of the American Beverage Corporation for $18.1 million in cash. Through a sale and leaseback agreement, $12 million was raised to apply against the purchase. *Exhibit 6* provides the terms and scope of this and subsequent acquisitions. This major diversification into soft drink bottling was accomplished without substantial dilution. Financing took place largely through sale and leaseback transactions, borrowing, and internally generated funds, with only one acquisition made by issuing common stock. In 1970 General Cinema had formulated its investment policy in the beverage division as one of "limiting capital outlays so that they would not exceed depreciation, leaving net profit for the retirement of debt." During the five years through 1975, capital expenditures for soft drink bottling amounted to $45 million, slightly exceeding the total depreciation figure.

During the early years, profits were modest when compared to either the theater operations or the company's total investment in soft drink bottling. In 1972, beverage profits even declined, which was explained in the annual report as "reflecting the heavy burden on gross margins resulting from the cost-price squeeze and our aggressive marketing efforts." During that year, General Cinema restructured the divisional organization and incurred heavy marketing expenses by being among the first to initiate tests with new resalable, returnable, 32- and 16-ounce bottles, which generated a higher profit margin. The annual report stated:

> Promotional and discounting expenditures for the introduction of the new packages were necessarily heavy to meet competitors' responses. Although largely nonrecurring and in the nature of an investment from which we expect future earnings, they were properly charged to current operating income. A second factor reduced earnings rather significantly for this division. Throughout most of the year we were caught in a cost-price squeeze from which we were unable to implement government-approved price relief until well into the third quarter, thus preventing us from offsetting about nine months of higher costs with normal price adjustments.

By 1975 Smith was describing the development of the beverage division as "one of the more successful diversifications of any company of our approximate size." He continued:

> The strategy we adopted to accomplish this diversification was to seek leisure-time, consumer-oriented areas, where we could use our management skills to operate a larger pool of assets, without substantial dilution of our stock. The soft drink industry, which we chose as the first major leg of our diversification, suited our objectives ideally. Soft drinks have enjoyed an extraordinary record of sustained, long-term growth. Per capita consumption of soft drinks during the past 10 years [from 1964 to 1974] has grown 65%. Soft drinks, which ranked a very weak number three among beverage categories in 1964, should become America's favorite beverage, surpassing coffee within a year. Another highly favorable trend has been the growth of the national brands paced by the four leaders—Coca-Cola, Pepsi-Cola, 7 UP, and Dr Pepper. We elected to seek a major position in the marketing of Pepsi-Cola, which we felt offered the best opportunity in the industry for future growth.

General Cinema had pursued a multifranchise concept of adding 7 UP, Dr Pepper, and other nationally franchised beverages to the Pepsi line of the acquired companies.

The organization of the beverage division had evolved from a decentralized to a centralized structure. Initially, a beverage operating committee (composed of both corporate and oper-

ating managers) supervised the acquisitions. Smith explained in 1971:

> Soft drink bottling is essentially a local business, and we bought a group of family-dominated companies. Other than consolidating some of the smaller acquisitions into the three large ones, we have left the organizations about as they were. I have resisted putting a single person in charge of beverages for a couple of reasons. First, I can't be sure whether there is anyone in the organization ready for the job yet. I would rather see how things go for a while before deciding who the person ought to be. Second, we didn't know much about the business when we made the acquisitions. Having someone between us and the market might have restricted the amount of information flowing up here. I keep in contact with PepsiCo, but other than putting in financial controls, evaluating capital requests, and discussing the timing of price increases, we haven't done much to interfere.

A single management team, however, was established in 1972 in Miami under President Herbert G. Paige, to whom three geographic division managers reported. Even though local plant autonomy was partially preserved, a strong professional staff was also created through the hiring of several key managers from other successful consumer products companies. Smith commented in 1976:

> Following this reorganization, professional management of budgeting, purchasing, production, and marketing became more sophisticated compared to anything previously accomplished by other independent bottlers. We had waited just long enough after the initial acquisitions to understand the basics of the soft drink business and to appraise the strengths and weaknesses of the people who had been managing the acquisitions. Thus we were able to select Herb Paige as a strong leader and to permit the creation of a strong central management. By the time we needed to restructure the organization, most of the people were prepared to support General Cinema's efforts to become "the best in the industry."

Industry Trends

The soft drink bottling industry operated on a long-standing franchise tradition. Franchised bottlers paid the franchiser for the concentrate to make the drink and were charged a fee to cover a portion of the franchiser's national advertising expenditures. In return, bottlers received exclusive rights to produce and market the product in a specified territory, an advertising allowance for a portion of their local advertising, some technical services in marketing and manufacturing, and various types of assistance in packaging, including the development of new containers. Bottlers had final responsibility for pricing, packaging, local advertising, and merchandising, although the franchisers attempted to encourage certain uniform policies.

In 1971 the Federal Trade Commission filed a suit to determine whether the exclusive sales territories franchised to bottlers represented a restraint of trade. The suit attempted to eliminate territorial restrictions in the sale of soft drinks across franchise lines, not the rights of franchised bottlers to bottle exclusively in their territories. In 1975 the administrative law judge hearing the case upheld the exclusivity of marketing areas. It was not yet clear whether the FTC would accept the decision or would initiate further proceedings. General Cinema management had repeatedly stated that its beverage business as a whole would not be adversely affected regardless of the outcome.

The three principal markets for soft drinks were food stores (44% of sales in 1975), fountains (21%), and vending machines (18%), with the remaining 17% coming from a wide variety of smaller outlets. Overall, Coca-Cola was the leader among soft drink franchisers with a market share of over 40%, about twice that of its nearest competitor, Pepsi-Cola. Coca-Cola was particularly strong in the on-premise (fountain) and "cold drink" (vending machine) markets, but in food stores its position was less dominant (see *Exhibit 7*). However, competitive shares varied considerably across markets. In some cities Pepsi-Cola outsold Coke by close to three to one, while in others the ratio was reversed. General Cinema managers attributed such variations, in large part, to the length of time the bottler had been in the market, the quality of route-delivery training and supervision, and the amount of advertising and "price-off" money the bottler was prepared to spend. Private labels had increased their share in the take-home market during the 1960s from less than 4% to over 10% (and to over 20% in chain stores), but during the 1970s their position had declined.

Cola-flavored drinks continued to dominate the soft drink market with about 60% of sales,

and diet drinks by 1975 had regained the share they held before the 1969 ban on cyclamates, which had greatly reduced their sales. Packaging changes had a substantial impact on the industry, adversely affecting the smaller bottlers. As a result, the number of bottlers fell from a peak of about 8,000 in 1960 to 2,400 in 1975. It was estimated that a few hundred of them accounted for more than two-thirds of the volume.

The 1960s saw a rapid acceptance of nonreturnable (NR) bottles and cans, which sharply increased packaging costs and permitted larger bottlers, who were able to effect lower production costs and lower delivery expense, to compete more aggressively on price promotions. This trend had also resulted in smaller margins for the industry as a whole. Another packaging trend favored larger bottles, which during the 1950s had accounted for only a small percentage of sales but had captured a continuously increasing share of the take-home market (see *Exhibit 8*).

Growing pressure from environmentalists to limit the use of one-way containers had resulted in legislative efforts in numerous states either to ban or to tax NR bottles and cans. Oregon and Vermont had passed such legislation. These environmental pressures brought about a sizable shift in 1972 from NR to returnable bottles. General Cinema's management felt that it would be less affected by restrictive legislation, as returnable bottles in 1975 accounted for 62% of its packages, a figure well above the national average. Also, the Oregon experience showed that major brands increased their market share at the expense of private labels and local bottlers.

The enormous cost increases that confronted the industry in 1974 appeared to be more critical than any of the above pressures. The major escalation of the price of sugar, together with inflationary cost increases for labor, other ingredients, packaging materials, supplies, and fuel, necessitated a 50% price adjustment to offset these rising costs. After a relatively flat year in 1975, sales resumed their upward trend in 1976, leading management to conclude that the demand for soft drinks was relatively price inelastic.

In the decade preceding these drastic price increases, industry sales had grown at an annual rate of over 7%. Only 0.9% of growth was attributed to a larger population and 0.1% to a changing mix in the population's age. Thus, nondemographic factors were seen as the major contributors to the growth in consumption of soft drinks. Industry observers mentioned packaging innovations, product availability, taste preferences, and marketing. They felt that soft drink sales would continue to grow, although at a somewhat lower rate of between 4% and 5% per year. General Cinema executives were equally optimistic, as Smith said in 1975:

> There are a number of positive trends which augur well for the soft drink industry. Even assuming only modest population growth, prevailing opinion is that per capita consumption of soft drinks should continue to increase about 5% per year, and we expect national brands to continue to garner a larger share of total industry volume. Demographics favor the industry in the teen-to-thirty age group, where the heavy consumers are. The present success of soft drink business had been largely built on sales to less than 20% of the population, who presently account for more than 70% of all consumption. Furthermore, we continue to see rapid growth in soft drink consumption in franchise areas where per capita levels are already double the national average.

General Cinema's Position and Policies

In 1976 General Cinema operated 21 beverage plants and 18 distribution centers, serving 7% of the population. Products were principally distributed in trucks operated by route salespeople to retail outlets and, in some instances, to distributors. The company also owned or leased coolers and vending machines to dispense products in factories, schools, service stations, and other locations. In virtually all of the markets serviced by General Cinema, Pepsi-Cola's market share was well ahead of that of major competitors and substantially exceeded Pepsi-Cola nationally. In all these areas combined, General Cinema's corporate share in the take-home market amounted to 37.7% in 1975 versus Coke's share of 29.3%.

Executives felt that General Cinema could outperform the industry. Smith explained:

> The geographic location of our franchises favors us, as their population growth rate is above the national average. We believe that our objective of increasing the market share of the three major brands we bottle from 35% to 50% is attainable. Also, per capita

consumption is considerably higher than the national average in many of our markets.

This optimism for the future was based on several factors, which Smith described as follows:

> The business is managed in a highly professional way by an experienced group, which is a blend of line managers with extensive soft drink experience and of sophisticated specialists with other consumer packaged goods backgrounds. We initiate our own marketing programs, which, we believe, is important in our ability to outperform other soft drink bottlers over the long run. The fact that many of our marketing programs have been imitated by the franchiser companies during the past two years suggests that we are having some success in pioneering new ideas and techniques for the soft drink business.
>
> Our Beverage Division management continually seeks to identify and capitalize on growth opportunities within the soft drink market. An example of this has been our stress on the larger-size growth packages. These packages represented less than 15% of food store soft drink sales four years ago; today they represent almost 35% of sales. Computerized information systems augmented by purchased market research data is instrumental in our ability to manage our pricing policies, control costs, distribution system innovations, major marketing activities, manpower allocation, and production efficiency. Centralized management control has also permitted economies of scale in purchasing raw materials—particularly sugar, packaging, advertising, and other important items. Finally, plant modernization and automation have created increased manufacturing efficiencies.

Other Diversification

Bowling Operations

The number of bowling centers operated by General Cinema grew rapidly to 15, having 494 lanes in 1963 and accounting for about 10% of corporate sales. However, difficulties were encountered from the outset, and as early as 1962 thoughts of a major expansion into bowling were put aside. The centers never quite reached the break-even point. Five of them were either sold or converted into cinemas between 1965 and 1967, and in late 1968 long-term leases with purchase options were issued to Consolidated Bowling Corporation for the remaining facilities for a fee that approximated General Cinema's annual expenses.

However disheartening the bowling interlude had been, Smith expressed the view that the experience had been a healthy one for the management group:

> We made some mistakes in entering the bowling business. For one, we misjudged our market. Rather than depending on families and the casual player, the bowling alley relies on blue-collar men's leagues in the evening and daytime bowling by women's groups—frequently the blue-collar workers' wives. The work force in New England is less blue-collar heavy industry than in the Midwest and is a lot more difficult to organize this way. We started to uncover the difficulty when we opened three centers outside of New England as part of our program to learn the business.
>
> To attract leagues, you should also be able to sell beer on the lanes. We found we weren't very good at securing liquor licenses. We underestimated the competitive response from the candlepin operators in New England.
>
> Withdrawing wasn't easy. The pinsetter manufacturers were competing with one another for good locations and putting pressure on operators to keep up. However, the operation was taking time away from theater expansion, and we began to discuss what ought to be done with it. Some of the group didn't want to accept a reverse and were in favor of trying to make it work. I thought we had given the business sufficient effort, and after a lot of discussion we finally decided to withdraw.

Communications

In 1968 General Cinema decided to enter the communications field and subsequently made investments in FM radio stations in Philadelphia, Houston, Cleveland, and Chicago; in AM and FM radio stations in Atlanta; and in a TV station in Miami. By the end of 1974, however, management decided that communications could not be a major division. It was felt that profitable stations commanded extremely high prices, which would not provide a satisfactory return because of the high 1974 interest rates and the requirements relating to the amortization of goodwill. In addition, management had been discouraged by continuing litigation with

respect to a proposed change from classical to contemporary music for its Chicago station. "It demonstrates the special difficulties and significant potential expenses which exist in the broadcast field and its attendant increasing governmental regulation," Smith said in 1976. Accordingly, a decision was made to withdraw General Cinema's investment in radio broadcasting "as a hedge against continuing losses in Chicago and a possible adverse decision in the pending litigation." Management indicated that, assuming the pending Atlanta sale was completed, the radio investment would be recovered with General Cinema retaining the Miami TV station and the FM stations in Philadelphia and Chicago.

Furniture Retailing

In 1972 General Cinema entered into an agreement to finance Alperts, Inc., in its development of a chain of 100,000- to 150,000-square-foot retail furniture warehouse showrooms. A pilot store was opened in the fall of that year near Providence, Rhode Island, with four more openings scheduled for 1973. Although management was convinced that the warehouse-showroom concept was fundamentally sound and represented a long-overdue change in a basic $10 billion industry, it limited its initial financial commitment to debentures convertible into 70% of the equity, with options for eventual 100% ownership. Operations were directed by the Alpert brothers, experienced and successful retail furniture merchants. General Cinema's background and expertise in the real estate field and its financial strength, coupled with the Alperts' furniture experience, were expected to provide the new company with a sound management base for significant growth.

General Cinema management felt that the warehouse furniture concept fit in with many of General Cinema's strengths and also had certain potential for growth, for a number of reasons. First, General Cinema's expertise in location selection and in managing and controlling geographically separate locations was an important factor. Second, warehouse furniture as a capital-intensive business permitted the use of leverage through sale and leaseback of properties and through leasing and inventory loans with General Cinema's credit. Third, as a new form of an old business, the effect would be similar to that of motels on hotels. Finally, if the initial trial proved successful, after a period of just one to two years the company could expand and open 10 to 20 locations in a two-year period, each location doing approximately $5 million worth of business. This project could then become an important segment of General Cinema's business.

In 1975, however, Smith commented:

> Our investment in Alperts Furniture doesn't look too promising at this time. Like all furniture retailers in this recession, it has suffered declining volumes in its three stores [in Providence, Albany, and Buffalo]. At our request, Alperts has reduced its total program to four stores, the last of which is under construction in Cleveland and will open in November. Furthermore, we have extended the time for decision about our future involvement with Alperts until 1981, and there will be no further expansion until we see some operating profits. In 1974 Alperts's operating loss was $334,000, and in 1975 it may lose over a million dollars. Although this is not a consolidated operation, we are reserving for Alperts's losses against our current earnings to prevent the buildup of any large future write-off. Our total cash investment in Alperts is about $2 million.

In 1976 the retail furniture warehouse stores were expected to lose $300,000, and management hoped that the company would break even in 1977.

Diversification: A Continuing Challenge

Smith went on:

> After the bowling venture, I didn't think seriously about diversification until our cash-flow picture started to change in 1966 and it became clear that we were going to have money to invest. We weren't afraid to think big. In 1967 we almost bought a $100 million vending machine company, which in many ways complemented our theater business. However, our P/E was only 10 then and the dilution would have been substantial because a considerable amount of stock would have had to be used. Everyone here was bullish about theaters as well and didn't want to risk a conflict-of-interest situation with other vendor operators.

The cash-flow picture that Smith referred to was caused by the fact that movie theaters were generating more cash than could be put back into theaters alone. In the mid-1960s, management decided that it would better serve stockholders, of which about one-third were financial

institutions, by becoming a company with substantial long-term growth potential rather than merely a dividend payer. It was decided to develop at least one and possibly two more operating divisions, with the goal of reducing theater-related earnings to approximately 50% of the total.

This goal had been achieved by 1975 through the soft drink bottling acquisitions and their subsequent success. Yet, as the large debt created by these acquisitions was gradually reduced and the cash flow remained strongly positive, management continued to see a need for further diversification.

In its two major businesses, General Cinema had limited its need for funds through a long-standing policy of leasing. Beverage plants were leased on a fixed rental basis and almost all the shopping center theaters on a fixed-plus-percentage rental basis. In 1975, rental expenses amounted to close to $22 million, of which $17.6 million constituted minimum annual rents. For theaters, the percentage had been steadily declining, and management viewed many of the leases, which had been negotiated in periods of lower construction and interest costs, as assets rather than liabilities, because it would cost substantially more to replace them at current costs.

In 1975 J. Atwood Ives, vice president and a director, commented on some of General Cinema's other financial policies that had improved its financial position:

> Several years ago, we decided that improving our debt/equity ratio and increasing our liquidity should be corporate objectives. The debt/equity ratio had been increasing steadily since our first beverage acquisition and peaked at 1.77 to 1 in 1970. This year, we will attain our first objective of reducing debt to a level lower than our equity for the first time since we began buying beverage companies in 1968.
>
> The second objective was to improve our liquidity by spreading out our debt maturities. Over the last several years, rapidly changing short-term interest rates have had a meaningful effect on our operating earnings, as we have had substantial amounts of debt tied to prime. In fact, we used to point out, based on approximately $55 million of debt outstanding tied to prime, that a percentage-point change in the prime rate added or subtracted five cents in annual per share earnings. This year we greatly improved our liquidity by completing a $30 million private placement of 15-year senior notes at 11%. The proceeds will be used to fund our present bank borrowings. This financing will have the added advantage of substantially lowering the amount of debt outstanding that is tied to prime, thereby reducing the impact on future operating earnings caused by significant swings in short-term interest rates. With the completion of this financing and the retention of our bank lines, we will have sufficient funds available to us to meet all anticipated capital requirements of our present businesses. Also, we will have achieved sufficient financing flexibility to move positively and promptly on any new opportunity for expansion into a third major division.

General Cinema's improved financial posture revived discussions about what had previously been referred to as "the third leg of the stool." Smith reflected:

> We are in the position again of having funds available for investment. I am interested in developing just one additional opportunity. When the company was smaller, it was O.K. to think about starting in a field from scratch, but that isn't as appropriate now as the purchase of an existing business. It should be big enough to have an immediate impact on earnings. It should have a capable management, good growth prospects, and a continuing need for investment. At the same time, General Cinema must be able to bring its competence to bear on the new business. I don't want to be dependent on the specialized skills of a few individuals. For that reason, highly technical or stylized or even manufacturing businesses are not really of interest.

Wintman stressed certain additional concerns related to diversification:

> I would like to continue in service businesses where we have some expertise. We should learn to be as proficient as those already in whatever business we enter. Rather than becoming dependent on an acquired management, I would feel more comfortable if we could do their job as well as they do if the need arose.

Lane, who had been associated with the company since 1949 and who had retired in 1976 as financial vice president, reflected on some of the reasons for General Cinema's success:

We have a tremendous pride in the accomplishments of General Cinema. Our executive group has been able to make quick decisions that have been essential in nailing down theater sites and making acquisitions. Our batting average has been pretty good so far. Dick Smith has a great deal of self-confidence and optimism that has given us the spirit to take controversial locations and make them work.

The beverage business looked like it might have been the solution to our diversification problems. We had found another noncyclical growth business that could be leveraged to the benefit of our shareholders. However, there just aren't many more good franchises around at the right price, and, if we bought one for cash, the new accounting rules for goodwill could hurt us.[4] The business is now self-sustaining and we are looking again.

As a means of internal communication and a guide for evaluating diversification opportunities, Lane in the early 1970s had summarized his understanding of the criteria to be applied in a memorandum reproduced in *Exhibit 9*. A more recent statement is given in *Exhibit 10*.

Smith described the process he was employing to search for opportunities:

I am doing most of the worrying about diversification myself. The process is time consuming; it took 15 months to work out the first soft drink acquisition. We don't have a planning or corporate development office at General Cinema. It doesn't make much sense when we're looking for only one opportunity. Nor have I asked consultants to prepare a study for us. However, I have put the word out through our Board[5] and the bank that we want something, and we're getting a number of inquiries.

General Cinema has amply demonstrated its recession-resistant and inflation-immune characteristics during the 1974–1975 period. It continues to aspire to earnings goals of a very high standard of a 15% to 20% increase annually. The achievement of its goals requires determinations not yet made concerning (1) the proportion of future growth to be achieved by acquisition as distinct from internal growth; (2) the specific directions and operating philosophies which flow from its acquisition policy; (3) the parameters for trading off financial conservatism for leveraged earnings growth; and (4) development of its own unique professionalism required for the effective management of a company clearly moving on from its entrepreneurial stage. Of course, the solutions for these problems will be sought with the aid of the entire executive group, assisted where appropriate by our board of directors.

4. Goodwill (the excess of purchase price over net tangible assets) created by acquisitions accounted for as a purchase had to be amortized over not more than 40 years, according to a 1970 opinion of the Accounting Principles Board.

5. The General Cinema board of directors had been broadened to include prominent chief executives of large companies located in the Boston area, an investment banker, and the president of a major commercial bank, in addition to some of the company's top managers. Corporate headquarters were relocated from downtown Boston to suburban Chestnut Hill.

Exhibit 1
Balance Sheet—Years Ending October 31 ($ thousands)

	1960	1970	1975
Assets			
Current assets			
Cash and short-term investments	$2,720	$12,562	$18,853
Notes and accounts receivable	–	4,683	9,810
Sundry deposits and receivables	103	1,465	6,624
Inventories	65	4,788	10,067
Other current assets	166	1,206	1,515
Total current assets	$3,054	$24,704	$46,869
Investments and advances			
Unconsolidated affiliates	$780	$942	$1,189
Broadcasting	–	2,153	15,138
Property, plant and equipment	na	$73,976	$137,901
Less depreciation	na	23,174	51,594
	$4,743	$50,802	$86,307
Other assets[a]	$610	$12,669	$22,489
Franchises, trademarks, and goodwill	–	22,174	31,495
Total assets	$9,187	$113,444	$203,487
Liabilities			
Current liabilities			
Debt due within one year	$294	$3,629	$3,498
Accounts payable	418	13,065	28,522
Taxes payable	568	4,679	9,478
Total current liabilities	$1,280	$21,373	$41,498
Deferred income tax	–	1,169	2,365
Long-term debt	1,021	58,086	57,852
Other	208	–	16,198[b]
Stockholders' equity			
Common stock	$1,186	$3,351	$5,589
Paid-in capital	10	4,441	11,880
Retained earnings	5,493	26,252	70,607
Treasury stock	(13)	(1,228)	(2,502)
Total	$6,676	$32,816	$85,574
Total liabilities	$9,187	$113,444	$203,487

Source: Company records

a. Other assets include unamortized leasehold expense of $6,984,000 in 1970 and $13,426,000 in 1975. The remainder is largely loans and accounts receivable due after one year.

b. Subordinated debt

Exhibit 2
Financial Data, Years Ending October 31 ($ thousands, except per share data)

	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Revenues										
Theater division	$33,672	$42,386	$54,294	$57,926	$70,101	$80,183	$99,621	$117,121	$142,873	$180,006
Beverage division	-	-	17,552	85,964	108,757	114,792	120,385	127,756	156,641	178,441
Total	$33,672	$42,386	$71,846	$143,890	$178,858	$194,975	$220,006	$244,877	$299,514	$358,447
Costs and expenses										
Theater division	29,711	37,790	46,570	48,994	59,048	68,062	85,964	102,746	127,770	161,572
Beverage division	-	-	15,033	79,393	101,536	105,987	111,967	119,316	144,229	161,106
Total	$29,711	$37,790	$61,603	$128,387	$160,584	$174,049	$197,931	$222,062	$271,999	$322,678
Operating income										
Theater division	3,961	4,596	7,724	8,932	11,053	12,121	13,657	14,375	15,103	18,434
Beverage division	-	-	2,519	6,571	7,221	8,805	8,418	8,440	12,412	17,335
Total	$3,961	$4,596	$10,243	$15,503	$18,274	$20,926	$22,075	$22,815	$27,515	$35,769
Corporate charges										
Interest	246	308	1,141	3,940	4,314	4,179	4,396	5,893	7,079	5,696
Corporate expenses	352	451	428	597	537	689	627	866	845	1,755
Income before taxes	$3,363	$3,837	$8,673	$10,966	$13,423	$16,058	$17,052	$16,056	$19,591	$28,318
Income taxes	1,348	1,647	4,080	5,396	6,418	7,648	7,321	7,210	9,002	13,449
Income before extraordinary items	$2,015	$2,190	$4,593	$5,570	$7,005	$8,410	$9,731	$8,846	$10,589	$14,869
Net income	1,982	2,286	4,988	5,947	7,015	9,198	10,349	9,442	11,057	14,869
Depreciation	1,345	1,529	2,669	6,122	7,407	9,045	10,764	11,161	11,939	12,659
Capital expenditures[a]	na	na	na	na	na	6,785	11,735	10,683	10,404	10,860
Total assets	27,151	29,876	62,472	109,790	129,144	138,782	172,385	178,999	193,208	203,487
Shareholders' equity	12,284	14,060	18,692	29,316	34,457	40,673	56,360	64,268	73,071	85,574
Per share data										
Net income	$.41	$.47	$1.03	$1.14	$1.30	$1.70	$1.86	$1.69	$2.01	$2.68
Dividends paid	.12	.12	.13	.17	.23	.28	.32	.34	.41	.465
Book value	2.58	2.91	3.84	5.55	6.53	7.76	10.27	11.69	13.29	15.51
Stock price range[b]	4.7–3.4	10.6–3.5	33.4–8.5	31.0–18.3	26.5–11.7	40.1–25.6	55.4–31.4	37.2–7.0	14.0–5.3	24.0–7.4

Source: Company records

a. Excluding new theaters and acquisitions

b. In eighths for calendar years, adjusted for splits

Exhibit 3
Statistics on the U.S. Motion Picture Industry

Year	*Admission Receipts ($ millions)*	*Average Admission Price*	*U.S. Recreational Expenditures*	*U.S. Spectator Amusement Expenditures*	*No. of Feature Films*[a]
1946	$1,692	na	19.8%	81.9%	na
1948	1,506	$0.44	15.5	78.5	na
1954	1,228	0.55	9.4	73.4	na
1958	992	0.65	6.3	64.5	na
1960	951	0.69	5.2	59.2	155[b]
1961	921	0.69	4.7	56.7	185[b]
1962	903	0.70	4.4	54.9	145
1963	904	0.74	4.1	53.4	150
1964	913	0.76	3.7	51.8	150
1965	927	0.85	3.5	51.2	165
1966	964	0.87	3.3	50.1	168
1967	989	1.19	3.2	47.7	215
1968	1,045	1.31	3.1	49.1	230
1969	1,099	1.42	3.0	48.6	325
1970	1,162	1.55	2.9	48.0	267
1971	1,198	1.65	2.8	47.3	281
1972	1,203	1.70	2.5	45.1	273
1973	1,292	1.76	2.5	44.6	229
1974	na	1.90	na	na	223
1975	na	2.03[b]	na	na	182

Source: U.S. Department of Commerce, Motion Picture Association of America, *Film Daily Yearbook of Motion Pictures*

a. Approved by Code Administration. In recent years, reissues of old films had become more common, averaging 39 per year from 1970 through 1975.

b. Estimated

Exhibit 4
Statistics on Motion Picture Theaters (number of screens at year-end)

U.S. Motion Picture Theaters

Year	*Indoor*	*Drive-in*	*Total*
1948[a]	17,811	820	18,631
1954[a]	14,716	3,775	18,491
1958[a]	12,291	4,063	16,354
1963[a]	9,150	3,502	12,652
1968[b]	9,500	3,690	13,190
1973[b]	10,850	3,800	14,650[c]

General Cinema Theater Units in Operation

Year	*Shopping Center*	*Resort and Suburban*	*Drive-in*	*Total*	*No. of Locations*
1960	4	19	26	49	49
1963	13	18	26	57	56
1968	125	10	49	184	154
1973	387	25	46	458	289
1976	641[d]	22	11	674	328

Source: *Boxoffice Magazine* and company records

a. Census

b. Estimate

c. From 1968 through 1973, new theaters opened at an annual rate approaching 300, requiring an average investment per theater estimated at $400,000 in 1973.

d. In 1976, there were 41 shopping center theaters with one auditorium, 188 twins, 55 triples, 11 with four, and 3 with five auditoriums.

Exhibit 5
Typical Cost Structure of a Chain Theater

Admissions		100.0%
Film cost		49.0
Gross profit before operating expenses		51.0%
Operating expenses[a]		
Advertising	6.0%	
Payroll	17.2	
Supervision	1.8	
Management fee and head office expense	1.5	
Repairs	0.8	
Insurance	0.5	
Utilities	3.3	
Real estate and property taxes	1.3	
Operating supplies and expenses	2.5	
Common area maintenance	1.0	
Other	1.3	
Total		37.2
Gross profit		13.8%
Concession sales	19.8%	
Concession profit		12.3
Net profit before depreciation, rent, interest		26.1%
Rent		11.5
Net profit before interest and depreciation		14.6%

Source: Company records
a. Excluding rent

Exhibit 6
Beverage Acquisitions

Year Acquired	Label	Location	Cost ($ thousands)	No. of Plants	Closed
1968	Pepsi-Cola	Dayton, Akron, Youngstown (Ohio); Miami (Florida)	$18,100	4	
	Private	Houston (Texas)		1	(1)
	7 UP	Miami	1,500	1	(1)
	Pepsi-Cola	Jacksonville, Gainesville, Ocala (Florida); Savannah (Georgia); Lynchburg (Virginia); Charleston (West Virginia); Bloomington, Seymour, Vincennes (Indiana)	8,900	8	(1)
	7 UP	Savannah	150		
1969	7 UP	Jacksonville	650		
	Pepsi-Cola	Cleveland (Ohio)	4,900	2	
	Dr Pepper	Dayton, Akron, Youngstown	100		
	Dr Pepper	Cleveland	100		
	Pepsi-Cola	Atlanta (Georgia)	3,300	1	
	Pepsi-Cola	Athens (Georgia)	1,100	1	
	7 UP				
	Dr Pepper				
	Dr Pepper	Vincennes	20		
		Illinois (5 counties)	40		
		Indiana (5 counties)			
	7 UP	Charleston	250		
	Pepsi-Cola	Gainesville (Georgia)	430	1	
1972	Dr Pepper	Lynchburg	440		
	7 UP	Atlanta	888		
1973	Pepsi-Cola	Sacramento (California); Winston-Salem, Greensboro (North Carolina); Springfield (Ohio)	15,118[a]	4	(1)
	Pepsi-Cola	Roanoke (Virginia)	1,710	1	
1975	Dr Pepper	Atlanta, Gainesville (Georgia)	1,223		
	Dr Pepper	Miami	800		
Total			$59,719	24	(4)

Source: Company records

a. This acquisition involved an exchange of shares; all others were made for cash.

Exhibit 7
Total U.S. Soft Drink Market Shares in Food Stores (8-ounce equivalent case basis)

	1965	1970	1971	1972	1973	1974	1975
Pepsi-Cola[a]	19.8%	19.9%	19.6%	20.2%	20.6%	20.9%	21.4%
Coca-Cola	19.5	21.4	21.1	21.0	20.9	21.0	21.3
Royal Crown	na	5.1	5.3	5.2	4.7	4.7	4.8
7 UP	7.2	7.2	7.1	7.1	7.2	7.3	7.1
Dr Pepper (reg.)	na	3.2	3.2	3.4	3.5	3.7	3.8
All diet products	15.5	9.4	11.6	12.8	13.8	14.2	16.6
Diet Pepsi	(3.0)	(1.8)	(2.0)	(1.9)	(1.9)	(2.1)	(2.4)
Tab	(2.5)	(1.0)	(1.6)	(2.3)	(2.7)	(2.6)	(2.8)
Diet Rite	(4.3)	(2.0)	(1.9)	(1.7)	(1.3)	(1.2)	(1.3)
Diet 7 UP	na	na	(0.4)	(0.4)	(0.5)	(0.5)	(1.4)
S.F. Dr Pepper	na	na	(0.3)	(0.4)	(0.6)	(0.7)	(0.9)
Private labels	na	13.1	12.8	12.4	12.2	11.3	10.2

Source: Company records based on A. C. Nielsen data

Note: Differences between 100% and totals for each year are accounted for by other brands.

a. Pepsi-Cola share has always appeared relatively stronger on an 8-ounce equivalent basis since it draws very little volume from the smaller size bottles, whereas Coke, Royal Crown, and 7 UP hold significant shares in small bottles.

Exhibit 8
U.S. Soft Drink Packaging Trends in Food Stores (in cases)

	1972	1973	1974	1975	1976[b]
Bottles over 17 ounces					
Nonreturnable	15.4%	16.8%	17.1%	18.2%	19.3%
Returnable	5.0	7.9	10.0	12.0	14.3
16-ounce returnables	18.6	18.0	18.1	19.7	20.4
All other bottles	32.8	27.6	24.5	22.1	20.2
Cans	28.2	29.7	30.3	28.0	25.8
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Returnable bottles	42.9%	41.5%	41.2%	43.0%	44.4%
Nonreturnable bottles	28.9	28.8	28.5	29.0	29.8
Cans[a]	28.2	29.7	30.3	28.0	25.8
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Company records based on Nielsen data

a. The long-term growth of cans was interrupted by the sugar-spurred pricing and discounting environment of 1975.

b. Six months

Exhibit 9
General Cinema Memorandum on Acquisition Objectives

We are presently engaged in two main areas: *Theaters* and *Soft Drinks*. We are not interested in becoming a conglomerate; we are interested in a third major division to absorb our increasing cash flow rather than use it to pay off debt.

Describing the third division in general terms is simple; in specific terms, difficult. It should be leisure-time-oriented, consumer-oriented, perhaps service-oriented and youth-oriented. It must have good potential for expansion to keep pace with our overall corporate growth rate of 15%–20% or better, with perhaps $2,000,000–$3,000,000 earnings. If smaller, it must be able to absorb infusions of capital for accelerated growth. In other words, it must provide a base for a third large division. Further, it should be a field in which it is possible to achieve a return on investment of at least 20% before taxes.

It is also fairly simple to rule out what we don't want: research and development, complicated manufacturing processes, involved or unique technology, cyclical or stylized characteristics; cash flow rather than earnings.

Possible fields—and these are by no means intended to be all-inclusive or exclusive—are:

BEVERAGES: Soft drinks (major Pepsi-Cola franchises, other national brands to complement the areas in which we now operate; no private label brands)

HOUSEHOLD FURNISHINGS

COMMUNICATIONS (earnings, not just cash flow)

EDUCATION

DIRECT MAIL MARKETING

ENTERTAINMENT: Motion pictures, musical

REAL ESTATE: Development services (earnings, not just cash flow)

OTHER SERVICES: Household, business, parking lots, vending

SPECIALTY RETAILING: Gifts, novelties, greeting cards, crafts, games, sewing, hobbies

Exhibit 10
General Cinema Memorandum on Preliminary Diversification Criteria

General Cinema's business is almost equally divided in terms of revenues and earnings between its theater exhibition and soft drink bottling businesses. Due to their nature, it is not necessary to reinvest in the business the major portion of the cash flow derived from these two operations, even though both are experiencing substantial internal growth. Over the last several years, since we have completed the major acquisition phase in the soft drink area, this excess cash flow has been used primarily to reduce long-term debt. General Cinema's principal operating philosophy is that of a growth company. Consequently, as our debt is paid down and our existing businesses do not require available cash flow, we are looking to acquire a third major operating division.

The following criteria have been prepared to help the company focus its search activities and to be of assistance to investment bankers and others who may be aiding us.

Financial Criteria

1. The business should have pretax earnings of at least $5 million and a potential to increase to $20 million.
2. The business should have the potential for a 15% or more annual growth in earnings and a 20% or more return on additional capital employed.
3. The business could require large capital inputs in order to increase its sales and earnings growth rate.
4. The company must have reported earnings and should *develop earnings*, not only cash flow, i.e., real estate development would not be acceptable.
5. The results of the acquisition should be nondilutive to General Cinema's earnings unless it is *small* with *great* potential.
6. The purchase price should approximate book value so as to avoid the addition of an excessive amount of goodwill to General Cinema's balance sheet.

Qualitative Criteria

1. The industry should not be technical or stylized, and the product or service should be immune to obsolescence.
2. The business should preferably be consumer and/or leisure oriented.
3. The business should have a relatively high barrier to entry or some other protective characteristics, i.e., brand leadership, license franchise, etc.
4. The company must have competent operating management capable of growing with the operation and of taking advantage of General Cinema's administrative and financial strengths. Basically, this new activity will be a management of assets for General Cinema with operating control in the hands of divisional management.
5. The potential market for the company's service or product should be on a large consumer base.
6. The company may be regional or decentralized, but should have a potential national scope.
7. The company's activities and primary market should be located in the United States.

July 9, 1976

WHARTON REPROGRAPHICS 7

Harvard Business School 375–246

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CIBA-GEIGY Corporation (A)

*Associate Professor **Malcolm S. Salter** prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.*

In the spring of 1974, the top management of CIBA-GEIGY Corporation was impressed with the opportunities that a major acquisition program in the U.S. could bring to the whole corporation. The company was the principal U.S. subsidiary of CIBA-GEIGY Limited, a publicly owned Swiss corporation. With the U.S. dollar undervalued, relative to the Swiss franc, and with prices on the New York Stock Exchange at a 10-year low, it appeared an opportune time to acquire U.S. companies at favorable prices. Officers of both the U.S. subsidiary and the Swiss parent hoped that reinvesting the U.S. cash flow in the United States would allow the U.S. subsidiary to repatriate dollars to the parent company under more favorable conditions in the future.

Diversifying acquisitions were of particular interest to Don MacKinnon, a vice president of CIBA-GEIGY Corporation, who was pressing the case for corporate diversification in the United States. In his view, diversifying acquisitions could help open up new paths of growth for the U.S. subsidiary, while providing a hedge against increasing R&D costs which were limiting the company's traditional specialty chemicals business. In 1973 the parent company reported that the group's U.S. sales had increased only 4%, in contrast to the worldwide average increase of 14% (measured in local currencies).

MacKinnon was interested in household products as one area of possible opportunity for CIBA-GEIGY. A recently formed acquisitions task force under his direction had already identified Airwick Industries as a possible acquisition candidate that could serve as an entreé into the household market. Since the task force had also identified attractive acquisition candidates in nonhousehold areas, MacKinnon was not sure whether the company should, in general, attempt to move into household products. He also had some questions and reservations about Airwick Industries in particular.

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The following cases describe both the choices facing MacKinnon and his colleagues in making their recommendations to the board of directors of CIBA-GEIGY Corporation and to the Swiss parent and the context in which these choices had to be made. This case describes the company's historical background, present operations, organizational setting, corporate objectives, and diversification philosophy, allowing the reader to gain an understanding of the company's overall corporate strategy. "CIBA-GEIGY Corporation (B)," HBS Case Services No. 9–375–247, describes Airwick Industries and the issues that CIBA-GEIGY's management faced as it tried to decide whether or not to acquire this company.

Company Background

The creation of CIBA-GEIGY Corporation paralleled the merger of the two parent Swiss companies, CIBA AG and J. R. Geigy AG, in October 1970. In contrast to competitors in Germany, England, the United States, or Japan, which could bank on their home markets for between 40% and 70% of their business, CIBA and Geigy had practically no home market. Approximately 98% of their sales were outside Switzerland, and both firms had significant holdings in the United States. The merger of the parent companies inevitably brought the two U.S. subsidiaries into one organization. By 1973 the newly structured U.S. subsidiary accounted for almost one-fourth of the merged companies' total sales. U.S. sales were distributed among principal markets as shown in *Table A*.

CIBA-GEIGY's products were almost entirely specialty chemicals—patent-protected, high technology products that had a specific purpose or filled a particular need. The company did not sell commodity chemicals, like sulfuric acid or caustic soda or benzene.

Table A
Breakdown of U.S. Sales, 1973

Business Line	*Total Sales (%)*
Agrochemicals	41
Pharmaceuticals	28
Dyestuffs & Chemicals	16
Plastics & Additives	13
Madison Laboratories[a]	2
Total	100%

a. Madison Laboratories sold such consumer specialties as breath spray, dental cream, and skin care products.

Table B
Worldwide Group Sales, 1973

Division	*SFr (millions)*	*Total Sales (%)*
Dyestuffs & Chemicals	2,047	24.5
Pharmaceuticals	2,338	29.0
Agrochemicals	1,673	20.5
Plastics & Additives	1,433	17.8
Consumer Products	246	3.0
Photographic Group	417	5.2
Total	SFr 8,154	100%

Although the company did not issue public financial statements, 1973 sales were described as being in excess of $550 million. The worldwide CIBA-GEIGY group, consisting of the Swiss parent and its 60 affiliated companies, had total sales of approximately $2.6 billion. This placed the group about No. 14 among the world's chemical companies. *Tables B* and *C* give a breakdown of sales by product area and geographic area for the entire group of companies. *Exhibit 1* presents the group's published financial statements for 1973. *Exhibit 2* shows the top management structure of the CIBA-GEIGY group of companies.

Current Operations

Headquartered in Ardsley, New York, CIBA-GEIGY Corporation had about 8,000 employees throughout the United States, most of whom were located at its principal facilities in New York, New Jersey, Alabama, Louisiana, Rhode

Table C
Geographical Distribution of Group Sales, 1973

Region	*Total Sales (%)*	
Europe	51	
EEC		35
EFTA		7
North America	26	
Latin America	9	
Asia	9	
Africa, Australia, and Oceania	5	
Total	100%	

Island, and North Carolina. The company's business was organized into four principal operating divisions:

Agricultural Division: It sold mainly pesticides, used by commercial farmers to improve crop yields by controlling weeds and insects. This was the company's largest division. Its particular strength was in the sales of herbicides used to control weeds in cornfields. CIBA-GEIGY's pesticides business was in a solid #1 position with 20% of the U.S. market.

Pharmaceuticals Division: It sold ethical pharmaceutical products through separate CIBA and GEIGY marketing organizations. Almost all of the division's products were prescription items, and they were advertised and promoted only to physicians, hospitals, and pharmacists—not to the general public. The division's most important groups of products were those used to treat hypertension, arthritis, depression, and diabetes. In pharmaceuticals, CIBA-GEIGY was among the seven largest companies in the United States.

Plastics and Additives Division: It sold a wide range of products, including epoxy resins, polymer additives, pigments, and fiberglass reinforced epoxy pipe. It was estimated that the company was #2 or #3 in epoxy resins and #1 or #2 in reinforced plastic pipe in the United States.

Dyestuffs and Chemicals Division: It sold synthetic dyestuffs used in the textile, paper, and leather industries. The division also sold a number of chemicals used to assist in dyeing and in textile finishing processes. In addition, the division did a large business in fluorescent whiteners, which soap and detergent companies used in their products to improve the appearance of the wash. In dyestuffs the company was #3 in the U.S. market after Du Pont and Sandoz, and in fluorescent whiteners the company was #1.

In addition to these principal operating divisions, a small consumer specialties business was run through Madison Laboratories. It was not considered to be a successful operation by the top management of the corporation.

CIBA-GEIGY was managed by the corporate managing committee, consisting of the chairman of the board, the president, and the five corporate vice presidents. Each of the operating divisions had a division president who reported to one of the corporate vice presidents. Each division president was backed up by a team of divisional vice presidents who were responsible for such areas as marketing, production, research, and administration. The divisions were responsible for their own activities in all of these areas, but they were free to call upon the corporate staff for necessary services. Once their budgets had been submitted to the corporate managing committee and approved, the divisions had considerable freedom to operate within their budgets. In capital expenditures, however, all projects over $100,000 required the specific approval of the corporate managing committee.

Two of CIBA-GEIGY's larger plants—Cranston, Rhode Island, and McIntosh, Alabama—served more than one division. In those plants the production activities were directed by the production vice presidents of the various divisions, but all the support services were managed by a corporate plant manager. The heads of all the corporate staff departments and corporate plants and facilities reported to one or another of the corporate vice presidents. *Exhibit 3* presents the organization chart of CIBA-GEIGY. The board of directors consisted of four company officers, four representatives from the Swiss parent company, and two outsiders.

Relations with the Swiss Parent Company

In the area of research there was considerable dialogue and exchange of information between the parent company and its U.S. subsidiary. Since both the subsidiary and the parent company invested large amounts of money in research, it was critical that these efforts be carefully coordinated. Similarly, capital expenditures were closely coordinated with the parent company to assure that the worldwide production capacity remained in balance.

Cash flow to the parent company from CIBA-GEIGY was an important link between the two entities and took four forms. First, dividends were paid to the parent company on an annual basis. Second, the U.S. subsidiary paid a significant amount of money to the parent company as part of its share of the group research budget. Third, cash flowed to the parent company in connection with royalty agreements. Finally, a minimal amount of cash flowed to Switzerland in payment for purchases of intermediate and finished products.

A regional services department in Switzer-

land was responsible for monitoring the group's investment in its 60 international affiliates. In addition, product line or division managers in each of the affiliates maintained close contact with corresponding divisions at group headquarters. The influence of the headquarters divisions was reflected mainly through the planning system. The three-year plans of each subsidiary's divisions were reviewed with the corresponding division in Basel.

Corporate Objectives

CIBA-GEIGY's objectives were to continue to improve its long-term profits through new products derived from research and from acquisitions in related fields. As explained by MacKinnon:

> We wish to remain a very research-oriented organization with vigorous and ongoing internal growth. However, we also look to our acquisition program as a means of complementing this growth. I should emphasize that we have no interest in becoming a vast conglomerate. We are not making acquisitions merely to become bigger. We are interested only in those companies that would complement our current business or put us into related new business areas.

MacKinnon added that acquisitions would be financed primarily with CIBA-GEIGY's own cash flows. The company was willing to invest up to $250 million in new acquisitions. Of this amount, $150 million was expected to come from U.S. sources.

CIBA-GEIGY's Acquisition Program

A first step in implementing the acquisition program was the creation of an acquisitions task force in September 1973. This group was chaired by MacKinnon and included CIBA-GEIGY's general counsel, corporate secretary, director of corporate planning, and three staff executives from the corporate planning and treasury functions. These three staff executives functioned as full-time members of the task force, reporting to Robert Terry, the director of corporate planning. The group initially had two major responsibilities: first, to establish basic criteria for any acquisitions the company might make; and second, to determine areas of acquisition interest.

A memorandum, spelling out acquisition criteria and areas of interest, was prepared by the task force and approved by the corporate managing committee. This set the overall guidelines for the acquisition search, and it was distributed to leading investment banking firms and large commercial banks so that these organizations could refer potential acquisition candidates to CIBA-GEIGY. (*Exhibit 4* presents this memorandum.)

In addition to contacting investment banking firms and commercial banks, CIBA-GEIGY also screened from 15,000 to 20,000 companies. Working with Standard & Poor's and Moody's industrial directories, the task force first reviewed approximately 10,000 publicly owned companies, evaluating them in terms of their criteria for industry and growth. This manual screening was complemented by a computer review by industry, conducted for CIBA-GEIGY by a leading investment banking firm. The company also purchased the Dun & Bradstreet computer tapes, which allowed the task force to review an additional 8,000 companies, most of them privately owned.

At the same time as this massive screening was going on, the task force worked with all of the company's divisions to identify any companies or divisions of other companies in which they might have had an interest.

After several months of screening, about 100 companies emerged meeting CIBA-GEIGY's general criteria. The task force then prepared a two-page summary covering each of these organizations for review by the corporate managing committee. A final selection of acquisition candidates was made from this group of 100 companies.

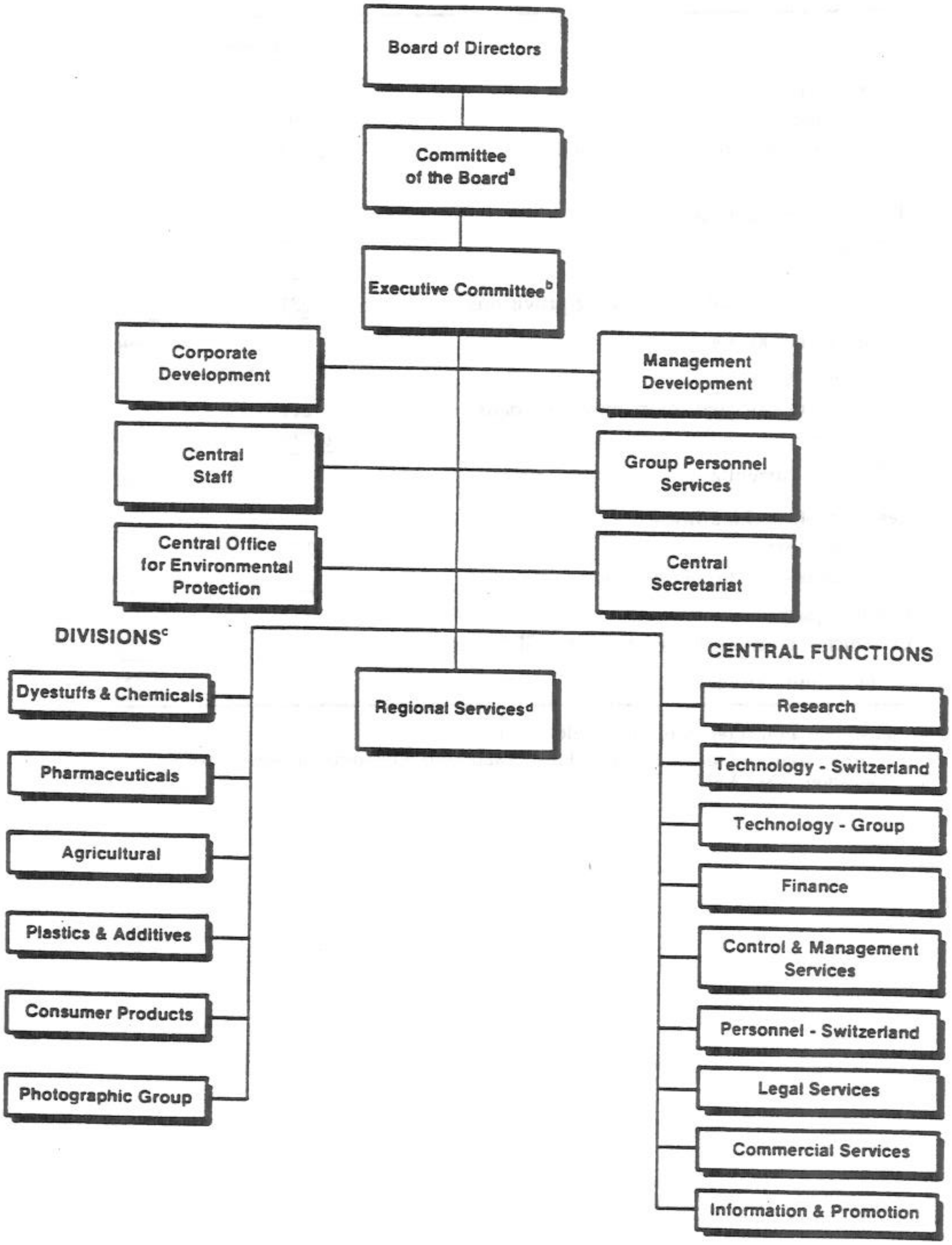
Exhibit 1
Consolidated Summary of Group Financial Status
(SFr in millions)

	December 31, 1973	
Current Assets		
Liquid funds	1,493	
Receivables and other current assets	2,234	
Stocks	1,925	5,652
Less Current Liabilities		
Suppliers	432	
Banks	945	
Other current liabilities, including provisions	1,281	2,658
Net current assets		2,994
Long-term Assets		
Interests in associated companies, and loans	244	
Fixed assets	6,326[a]	6,570
Total net current assets and long-term assets		9,564
Less Long-term Liabilities		
Debenture loans	375	
Other loans and long-term liabilities	957	1,332
Group Equity		
Of which minority interests represent SFr 138m.		8,232
Total equity and liabilities		12,222

Source: 1973 annual report of CIBA-GEIGY Limited.

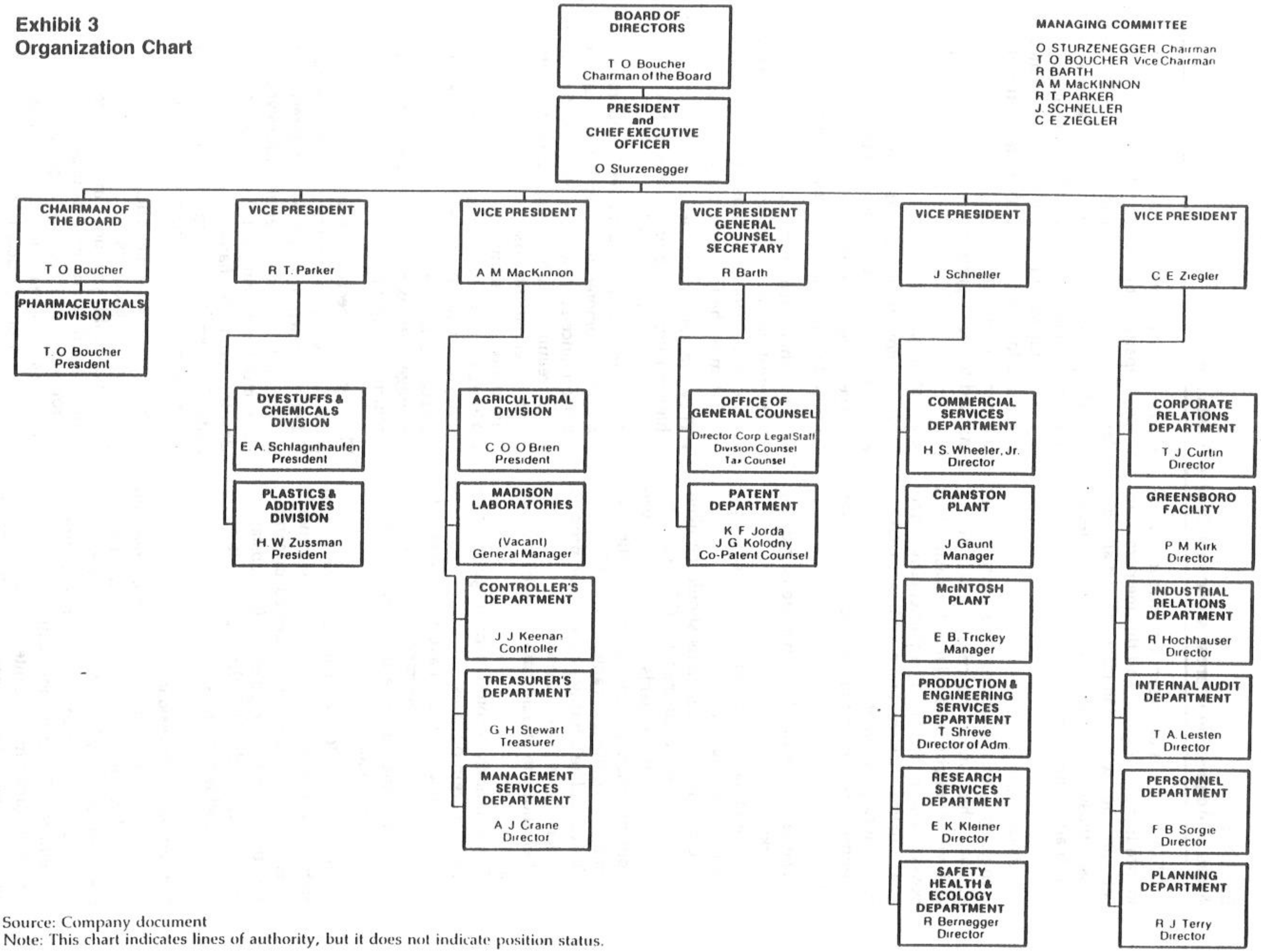
a. Current value; use of acquisition value less appropriate depreciation would give a valuation of SFr 3,997m.

Exhibit 2
Top Management Structure of CIBA-GEIGY Limited Organization



a. Prepares the fundamental principles of business policy for consideration by the board, supervises business activity, sanctions investment projects in excess of SFr 10 million, and deals with fundamental questions of personnel, investment, and financial policy.
b. Responsible for the implementation of business policies approved by the board.
c. Responsible for worldwide strategy in specific market sectors. Reviews specific product-market strategies of operating companies.
d. Monitors the group's investment in its 60 international affiliates. Reviews overall business plans of subsidiaries and parcels out sector strategies to group-level divisions for review.

Exhibit 3
Organization Chart



Source: Company document
Note: This chart indicates lines of authority, but it does not indicate position status.

Exhibit 4
Areas of Acquisition Interest & Consent Decree Provisions

CIBA-GEIGY is at present entering into a major acquisition program, and this memorandum sets forth our acquisition interests and also discusses those provisions of the consent decree which affect our interests.

Acquisition Criteria

In general, we are looking for acquisition candidates which meet the criteria listed below, and which might be available for cash. It is possible that in the case of a particularly attractive situation, we might be willing to take a major stock position offering the probability for a control position or full ownership at a later date.

1. The candidate should participate in growing markets.
2. The candidate should have a proprietary position in its markets.
3. The candidate's operations should be likely to be favorably affected by CIBA-GEIGY's know-how in the fields of research, development, manufacture, and marketing of complex synthetic organic chemicals.
4. The candidate's business should be product rather than service oriented.
5. The candidate should have sales of $50 million or more.
6. The candidate should earn a good gross profit margin on sales.
7. The candidate should have the potential to yield a return on investment of 10% or more.
8. The probable purchase price should not exceed $250 million.

Since CIBA-GEIGY's business in the United States approximates 25% of the worldwide sales, we are particularly interested in companies that would offer potential for substantial growth outside the U.S. through the efforts of our worldwide resources.

Consent Decree Provisions

Under the terms of the consent decree into which CIBA and Geigy entered at the time of their merger in 1970, CIBA-GEIGY Corporation and its parent company, for a period ending in September 1975, may not acquire "any other person engaged in the United States in any of the same lines of commerce" as CIBA-GEIGY Corporation, except upon 15 days prior notice to the Department of Justice. If within such 15 days prior the Justice Department requests information relating to the proposed transaction as authorized by the Antitrust Civil Process Act, then the transaction cannot be consummated until an additional period of 60 days after the company furnishes the information so requested to the Department of Justice.

Areas of Acquisition Interest

We are not interested at the present time in exploring totally new business areas. We have, however, been able to identify the following areas of growth which we wish to pursue:

1. The whole area of specialty chemicals is of interest to us. A definition of specialty chemicals would include, among others, certain of the following characteristics:

- They are sold in moderate volumes, but at high per-unit selling prices, at least two times raw material costs.
- They are usually sold under brand names, and are promoted to the end user based on performance specifications for what they do.
- They require a relatively high level of research and development, based on a knowledge of the customer's technology.
- Although gross profit margins typically run at least 50% of sales, heavy expenditures for marketing and research may yield only an average after-tax margin on sales, but a high return on investment.

The types of specialty chemicals we currently produce are listed in the previous section. Other types which could be of interest to us include such items as: specialty adhesives, biocides, moulding compounds, coatings, specialty cleaning products, flame retardants, intermediates for cosmetics, detergents, etc., chemicals for pretreating and finishing textiles, etc.

2. Proprietary pharmaceuticals and cosmetic and toiletry products.
3. Animal health products, including feed additives and veterinary products.
4. Proprietary household and garden products such as those marketed by S. C. Johnson.
5. Suppliers of products to the health care industry, including disposable hospital and

Exhibit 4 (continued)

medical products, diagnostic aids, dental and optical supplies.

6. Products, processes, and related services for the environmental industry, i.e., air, liquid and solid waste treatment. It should be noted that our interest in these areas is not in the equipment side, but our orientation is toward the chemicals and related services side.
7. Photo chemicals and related products.

We have not included such items as seed breeding and food additives (principally flavors and fragrances) on the above list as our Agricultural Division has already conducted extensive studies in these areas using outside consultants, and it has identified most of the candidates which might be of interest to us.

8 WHARTON REPROGRAPHICS

Harvard Business School 375–247

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CIBA-GEIGY Corporation (B)

*Associate Professor **Malcolm S. Salter** prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.*

In June 1974 the top management of CIBA-GEIGY Corporation was presented with a detailed task force report on Airwick Industries, Inc. CIBA-GEIGY had decided to concentrate its acquisition activities on six companies, and Airwick Industries was one of the six. While detailed reports were prepared from public sources on each of the six companies, a special Airwick task force from CIBA-GEIGY had actually interviewed key vice presidents at Airwick Industries. This unusual procedure reflected both management's understanding that Airwick was looking for a merger partner and Airwick's friendly disposition toward CIBA-GEIGY. For five years a French subsidiary of CIBA-GEIGY Limited had distributed Airwick products in France.

Based on this report and publicly available information, Don MacKinnon, a CIBA-GEIGY vice president, and the acquisitions task force had to decide whether or not to give their support to this potential acquisition. Since MacKinnon was the only executive at CIBA-GEIGY with extensive mergers and acquisitions experience, his opinion would be a highly respected input to the final decision. If management decided to seek the acquisition of Airwick Industries, an overall plan had to be prepared, including a starting position and a desired end position for negotiations with Airwick's board of directors.

This case summarizes the basic substance of the Airwick task force report, along with the publicly available information on Airwick Industries. In addition, it presents the issues and questions raised by MacKinnon and the task force as they considered whether or not to proceed with this diversifying acquisition. (See "CIBA-GEIGY Corporation (A)," HBS Case Services No. 375–246, for background information on the corporation and its acquisition program.)

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Airwick Industries

Company Background

In the late 1930s, an independent researcher worked with a blind subject for four years in an attempt to discover the natural odor opposites of the most common indoor malodors. On the basis of this work, he was able to develop an odor counteractant formula made up of 125 components including, among other things, a group of green plant extracts. It was this combination product, called Airwick Liquid, which eventually formed the business base of Airwick's predecessor.

Until Airwick Liquid was developed, most odor-control products simply masked or overpowered unpleasant odors with a strong and supposedly more pleasant aroma. Airwick Liquid was, therefore, unquestionably a salable product, but substantial resources were required to penetrate the post-World War II home-centered market. To overcome the lack of financial resources, the responsibility for developing a sales force and distribution system was assigned to a national distributor, while the company—then known as Airkem, Inc.—limited its marketing efforts to products for industrial, commercial, and institutional applications and to exploring foreign markets.

By the mid-1950s domestic retail sales of Airwick began to sag under intense competitive pressure. Even a transfer of marketing rights to Lever Brothers could not reverse the sales deterioration. In 1963 the company purchased the Airwick name from Lever and began to market Airwick Liquid itself. The company spent a good deal of money promoting the product that year which resulted in a net loss in 1963, but sales stopped declining. The company was profitable through 1974, although development costs and promotion for new products penalized earnings growth in the late 1960s.

As of June 1974 the company's principal products consisted of odor-counteracting air fresheners, together with a full line of sanitary maintenance items such as disinfectants, cleaners and insecticides containing odor counteraction features, and certain swimming pool products. These products were marketed through four operating segments:

1. **Consumer**—household products distributed through food brokers in the United States and Canada.
2. **Institutional**—commercial, institutional, industrial products distributed through franchised distributors and 14 company branch offices in the United States and Canada.
3. **International**—household, commercial, institutional, and industrial products marketed through distributors in more than 50 foreign countries.
4. **Aquatic**—swimming pool treatment chemicals and dispensers sold through distributors and dealers in the United States and Canada.

Table A shows the revenues and pre-tax income for each of these segments from 1969 through 1973.

The relative profitability of the principal segments of the company's business significantly changed, beginning in 1971, due to three major factors.

1. Consumer segment sales and margins increased sharply after 1970, reflecting:
   a. the completion of national distribution and the market acceptance of a new product, Airwick Solid, in United States retail markets, and
   b. manufacturing efficiencies resulting from integrated, higher volume production of this product within the company's plants.
2. Earnings of the institutional segment declined, reflecting higher marketing expenses and increased costs of goods, warehousing, and transportation not offset by increases in selling prices.
3. International sales and margins increased, reflecting the broadening distribution and market acceptance of Airwick Solid in European retail markets.

Exhibits 1 and *2* present Airwick Industries' consolidated statement of earnings for the period 1969–1973, and a balance sheet as of December 31, 1973.

Consumer Segment

The Airwick consumer brands division marketed six products, three of them in the air freshener category. The three air fresheners—Airwick Solid, Airwick Liquid, and Airwick Spray—accounted for 97% of the division's net sales. The remaining 3% included On Guard, an automatically dispensed toilet bowl cleaner; Airwick Cat Litter Deodorant Spray; and a disinfectant spray. In 1973 all of the consumer division's profits were derived from Airwick Solid and Airwick Liquid.

Table A
Revenues and Pre-Tax Income for Major Operating Segments, 1969–1973 ($ in thousands)

	Consumer				Institutional			
	Revenues		Pre-Tax Income		Revenues		Pre-Tax Income	
1973	$17,500	52%	$2,475	49%	$9,100	27%	$ 800	16%
1972	14,251	51	2,090	55	8,117	29	429	11
1971	11,066	50	1,222	47	7,048	32	615	23
1970	6,785	43	(23)	–	6,380	40	931	69
1969	4,606	37	(304)	–	5,835	46	1,210	86

	International				Aquatic			
	Revenues		Pre-Tax Income		Revenues		Pre-Tax Income	
1973	$4,050	12%	$1,500	30%	$2,950	9%	$250	5%
1972	2,920	11	1,047	28	2,485	9	221	6
1971	1,895	8	590	22	2,158	10	203	8
1970	1,294	8	386	29	1,468	9	58	4
1969	1,022	8	310	22	1,118	9	193	14

Table B
Air Freshener Retail Market, 1970–1973 ($ in thousands)

	Total Market		Solids		Aerosols		Liquids	
	$ Sales	Change from Previous Year	Share of Total	Change from Previous Year	Share of Total	Change from Previous Year	Share of Total	Change from Previous Year
1973	$91,400	+34%	43%	+110%	34%	±0%	23%	+9%
1972	68,000	+16	27	+73	45	+9	28	+1
1971	58,400	+13	19	+90	49	+22	32	+8
1970	51,700	na	11	na	55	na	34	na

The air freshener market had shown substantial growth in the early 1970s, with the bulk of the growth in the solid type of product. *Table B* summarizes the key sales trends for the 1970–1973 period. In addition to having experienced rapid growth, the air freshener market was highly competitive. Many manufacturers and distributors were trying to stake out a position in the market for room deodorants. A number of competitors were larger, better known, and financially stronger than Airwick Industries, and they were capable of expending large sums in advertising and promoting their products.

Airwick's major competitors included Bristol-Myers with its Renuzit brand, American Home Products with Wizard, Home Products Corp. with Days-Ease, and S. C. Johnson & Company with Glade. Intense competition developed in 1973 in the solid segment of the household air-freshener market. While the market was expanding significantly, competitive products proliferated. American Home Products was a new entrant, and it was believed that Gillette was also preparing to enter the market. *Table C* shows the share of market for the four-week period ending March 15, 1974, and for the comparable period in 1973. The averages for the two years are also summarized.

Table C
Air Freshener Market Shares in Food Stores
(dollar basis, expressed in percents)

	4-Week Shares		*Average 52-Week Shares*	
	Ending 3/16/73	*Ending 3/15/74*	*Last 12 Months*	*Year Ago 12 Months*
Airwick Liquid	4.5	4.9	4.4	4.7
Airwick Solid	19.1	17.0	16.1	18.7
Total Airwick	23.6	21.9	20.5	23.4
Renuzit Aerosol	6.7	6.5	6.8	7.0
Renuzit Solid	11.8	21.6	17.0	10.3
Total Renuzit	18.5	28.1	23.8	17.3
Wizard Aerosol	10.7	8.8	10.3	12.8
Wizard Solid	–	5.7	3.3	–
Wizard Wick	2.3	1.9	2.3	2.6
Total Wizard	13.0	16.4	15.9	15.4
Days-Ease Solid	5.5	6.2	7.5	1.3
Glade Aerosol	20.1	9.8	15.0	17.6
All other brands	19.3	17.6	17.3	25.0

As can be seen from *Table C*, Renuzit eclipsed Airwick as the #1 brand (all forms combined). Consumer research in the solid segment showed that Airwick had maintained strength, however, with an extremely high 92% consumer intent to repurchase after trying the product.

In early 1974 Airwick was prepared to produce private-label solid air fresheners for chain stores. The company had already signed production contracts with Grand Union, Purity, and Finast; a contract with A&P was about to be signed. Airwick managers predicted that the private-label business would be as profitable as the existing Airwick Solid business on a per-unit basis.

The idea behind Airwick's entrance into private labeling was to eliminate competition while gaining more factory volume for Airwick. In areas of the country where Airwick Solid had excellent distribution and was #2 it was believed that, when the chain added the Airwick brand to the shelf, the marginal #3 or #4 brands would be taken off the shelf. In areas where Airwick Solid did not do as well, private branding was thought to be a way of getting into the store and protecting Airwick from competitors who also might be interested in doing private-label work.

Despite Airwick's planned entrance into private labeling, the company had been notably unsuccessful in developing and introducing new products. In the past, all new product introductions—Airwick Solid, Cat Litter Spray, On Guard, and the disinfectant spray—were formulas taken directly from products sold by the institutional division. With the exception of Airwick Solid, they were all unsuccessful.

Airwick consumer products were sold through a system of 63 food brokers across the United States. These brokers were under the supervision of 7 Airwick-employed regional managers who reported to the sales manager. Due to the desperate situation in 1963, when the existing broker network was established, Airwick started and continued paying commissions at the rate of 7.5%. While there were many exceptions, the standard industry commission over the years was 5%.

Heavy advertising was an important part of Airwick's marketing program. Given the increased competition, it appeared that advertis-

ing expenditures would have to increase in order to maintain the company's position against competing products.

Institutional Segment

The Airkem institutional division was responsible for two classes of products: commercial products and emergency odor-removal products. Commercial products contributed substantially to all of the division's sales and profits.

Commercial products included a semisolid odor counteractant called Solidaire, liquid and spray odor counteractants, odor-controlled insecticides, and sanitary maintenance items such as disinfectants and detergents. The division also designed, manufactured, and sold equipment to dispense a number of these products; in Canada, it marketed a line of floor and carpet-care equipment manufactured by another firm. Commercial products were used by institutions such as hospitals, nursing homes, schools, and motels. Specialized odor-controlled formulations were sold for spray-system applications in atmospheric control of odors emanating from factories and other industrial establishments.

Emergency odor-removal products included counteractant formulations designed to remove or reduce certain odors, such as the odor of smoke from fire in residences, automobiles, and commercial and industrial establishments.

The division sold its products principally through about 55 franchised distributors who were responsible for sales in specified geographic areas in the United States and Canada. These distributors resold the products to the ultimate users, or in some cases used them in rendering services to their customers. The franchised distributors in the United States normally used the name Airkem in their trade styles.

The division also acted as its own distributor of Airkem products, and it performed all the functions of a franchised distributor through branch offices in 14 geographic areas, 4 of which were added in 1974. Compared with sales to distributors at the wholesale level, branch office sales direct to consumers produced higher revenues, but the start-up and staffing costs of the branches created higher operating expenses which adversely affected the earnings of the institutional division since 1971. In total, the branch offices accounted for 31% of the institutional division's sales in 1973.

The division advertised the products trademarked Airkem nationally, principally through print media, and it supplied distributors with merchandising aids and promotional literature. In institutional markets, Airwick competed with many large and small firms; no one firm dominated the market.

The institutional division competed in a growing market that was estimated to be $500 million at the consumer-dollar level, or about $250 million in terms of factory dollars. There was very little information on the size and breakdown of the market; unlike the consumer segment of the business, there was no auditing information service like SAMI.

International Segment

Airwick's household products and some of its institutional products were also marketed abroad. Marketing in Europe and other international markets was managed by Airkem (Export) Limited, a British subsidiary. This subsidiary accounted for about 97% of the sales and substantially all of the profits of the international segment. Its principal plant, located in Hitchin, England, manufactured Airwick concentrates. Marketing in Latin America, the Caribbean, and Taiwan was managed from the home office of the company.

In building up its European-based business, Airwick had adopted the policies of not participating in advertising expenditures (except for the U.K.), not interfering in local marketing issues (all major marketing decisions were left to the distributors), and not signing long-term contracts with distributors.

Pre-tax margins overseas were higher than at home because more expenses were assumed by the overseas distributors than by U.S. distributors. The plant at Hitchin produced the compounds and concentrates sold by the international segment, while the distributors did the finishing and packaging.

Competition in foreign markets was generally less intense than in the United States, since odor counteractants and related products were relatively new. The potential for growth in Europe was considered particularly good. While past growth in the international segment was almost entirely due to Airwick Solid, further exploitation of the Airwick Solid concept and the systematic development of the institutional markets provided a possible source of continued growth in the major EEC countries.

Aquatic Segment

The aquatic segment of the company was made up of King-Kratz Corporation and Seablue Corporation. The King-Kratz Corporation, acquired by Airwick in October 1972, produced and marketed a line of chemicals and dispensers for water treatment in swimming pools. King-Kratz and its competitors purchased their basic ingredient, isocyanate, from Monsanto and FMC and then tableted or packaged the various products for sale. King-Kratz products were sold to companies engaged in distributing swimming pool supplies and equipment. These distributors sold to dealers who in turn sold or used the products in providing services to pool owners.

Seablue Corporation, acquired by Airwick in January 1974 for $4 million in cash, was a distributor of swimming pool equipment and supplies sold under the trademark Seablue. It also manufactured and sold high-rate sand filters and diving stands. Seablue Corporation had sales and distribution centers in Atlanta, Baltimore, Charlotte, Cincinnati, Dallas, Houston, Kansas City, Memphis, Miami, and New Orleans; it sold products to swimming pool builders, swimming pool maintenance and service companies, and specialty stores. Prior to its acquisition by Airwick, Seablue Corporation was the largest customer of King-Kratz Corporation.

Swimming pool chemical needs were predicted to grow at 11% during the 1971–1975 period. Approximately one-half of these requirements were expected to be for in- and on-ground pools, with the remaining amount for above-ground pools. (Above-ground pools were the round ones usually found in backyards.) King-Kratz had a strong position in the in-ground market, and it was also strong in nonresidential pools. Management expected growth in these segments to continue, provided raw materials were available. To get a foothold in the above-ground segment, however, King-Kratz would have to develop a homeowner-oriented product line and get it to mass merchandisers. This, it was thought by management, would require additional financial and marketing resources.

In 1974 King-Kratz was attempting to get closer to the dealer and preparing to "go direct" in the near future. This modification in distribution policy was expected to result in substantially increased marketing expenses since the division would (1) pick up new customers to service, (2) be shipping more orders to more customers in smaller lots, and (3) have to spend more contact time with individual dealers.

Seablue's plans included adding products to its line of chemicals (which it purchased from outside suppliers) and diving boards, stands, and filters (which it manufactured). The company also envisioned backward integration by having King-Kratz manufacture more of its own products, making more plastic parts itself, and moving products back from Seablue to King-Kratz for national distribution. In 1974, Seablue was among the lowest performing profit centers in the company. *Exhibit 3* shows Seablue's earnings statement for 1971–1973.

Advertising

In 1974 Airwick advertised Airwick Solid and Airwick Liquid on a national basis. It advertised On Guard and the Cat Litter Spray in certain selected markets. It also advertised the products trademarked Airkem nationally and supplied distributors with merchandising aids and promotional literature. Though Airwick was a leading advertiser in the air freshener market, the company could not spend as heavily on advertising as some of the companies with which it competed. *Table D* shows the total advertising expenditures for the leading marketers of deodorizers and air fresheners during the first six months of 1974.

Table D
Top Five Advertisers
January–June, 1974 ($ thousands)

Brand	*Advertising Expenditures*
Renuzit	$1,883.1
Airwick	1,615.2
Wizard	1,594.7
Days-Ease	917.3
Glade	708.9

Source: LNA Multi-Media Report Service, Vol. 2, No. 2.

Manufacturing

In the United States, Airwick manufactured its formulas at its Carlstadt, New Jersey, plant by compounding essential oils, aromatic chemicals, and emulsifying agents. The formulas

were then blended with other ingredients and packaged into finished products at Carlstadt and at a second manufacturing facility in St. Peters, Missouri. The company also manufactured plastic packaging components. The King-Kratz products were processed at the company's Missouri plant. Swimming pool filters and diving stands were manufactured at the Seablue plant in Richardson, Texas.

In Canada, Airwick had in the past subcontracted the manufacture and packaging of most products. In June 1974 the company began producing some products at a newly leased Canadian facility, and it anticipated that most products would be in production at that facility by the end of 1974. The company's British subsidiary manufactured the formulas at its plant in Hitchin, England, which were then transferred to independent distributors to be packaged as finished products and sold under Airwick's trademarks. In Latin America and the Caribbean, most of the products were imported in finished form from the United States.

Most of the raw materials used by Airwick were regular articles of commerce and had been historically available in sufficient quantities for its manufacturing operations. Since the latter part of 1973, however, the company had experienced industrywide shortages of some basic chemical components, including chlorine and disinfectant chemicals. These shortages limited the company's ability to expand sales and production in its institutional and aquatic marketing segments.

Research and Development

Airwick's R&D program was primarily directed toward the development of new products and the improvement of present products. Theoretical studies were conducted on release mechanisms for odor-control products and odor perception, counteraction, and measurement. Company engineers designed and developed dispensing units, and designed and maintained molds used in making containers for the company's products. The R&D department was responsible for quality control and package design for the company's products, and it also furnished technical assistance to the field sales organization.

There were 38 employees in this department in 1974, of whom 26 held degrees in chemistry, biology, or engineering. Expenditures for company-sponsored R&D were approximately $418,000, $488,000, and $629,000 during 1971, 1972, and 1973, respectively, and $671,000 was budgeted for 1974.

Recommendations of the Airwick Task Force

After two weeks of interviewing and analysis, the Airwick task force concluded that if CIBA-GEIGY had a strategic interest in entering the household products business, Airwick could be an attractive way of doing it—assuming the price was not excessive. The detailed findings of the task force included the following points:

1. Airwick is a profitable company whose earnings may have temporarily plateaued due to severe competition in the consumer segment of their business.
2. Competition in the consumer segment of the business will definitely restrict growth and reduce profitability of this segment in the immediate years ahead. Indeed, without a more carefully prepared marketing plan, a well-conceived new products program, and additional advertising expenditures, it will be difficult to achieve an increase in sales of much more than 5% to 6% annually.
3. The institutional segment of Airwick (Airkem Institutional Division) is in excellent shape. They have good management, good products, and a good marketing program. They participate in a large, fractured market where the leading competitor is estimated to have only 8% share of the market as compared to an estimated 5% for Airwick. There is good potential for this division.
4. The international segment appears to be a profitable part of Airwick in terms of contribution as a percent of revenues. Current growth rates can most likely be maintained.
5. While the aquatic segment appears to be healthy, it does not appear to be the kind of business that would normally be attractive to CIBA-GEIGY.
6. Airwick's present financial position is difficult because of a need for cash. At year end 1973 the company had only a minimum of debt outstanding, but as of May 7, 1974, it had $8 million in short-term loans outstanding paying prime interest rates. The cash shortage seems to have been caused by the recent acquisition of the Seablue Corporation for $4 million in cash, the necessity of building inventories for the aquatic segment of the business which is seasonal, and the

turndown in Airwick's consumer business over the last nine months.

7. Production is relatively simple and efficient. While the new St. Peters plant is impressive, the Carlstadt plant is overcrowded and needs immediate relief.
8. The R&D activity appears to be suffering from underfunding and a lack of direction.
9. Airwick appears to be highly people-oriented. The president addresses a substantial number of employees by their first name and seems to know a great deal about them. This personal attention is reflected in their benefit programs which appear to compare favorably with those of CIBA-GEIGY.
10. Potential synergisms:
    a. Madison Laboratories has personnel with marketing skills which may help Airwick; Airwick has the sales organization that Madison Laboratories lacks.
    b. CIBA-GEIGY has money which Airwick needs to grow.
    c. CIBA-GEIGY has available space and equipment which may be useful to Airwick.
    d. CIBA-GEIGY's chemical ability and research facilities could improve Airwick's products and provide Airwick with a better R&D effort with little increase in incremental costs.
    e. CIBA-GEIGY's Agricultural Division has products which could be marketed by Airwick.
11. A savings of $1 million in Airwick's overhead could be achieved which would add to the return of any contemplated investment in Airwick.

Questions Raised by MacKinnon and the Acquisitions Task Force

Despite the conclusions of the Airwick task force, Don MacKinnon and the acquisitions task force were concerned with several unresolved questions. For a start, it had not yet been firmly decided whether or not CIBA-GEIGY should be in the household products business. Neither was it clear that Airwick Industries was the best vehicle for developing a position in this business if, indeed, it was decided that household products was an appropriate field for CIBA-GEIGY. In addition, there was concern as to how to go about valuing a company whose major division was in a deteriorating competitive position. Linked to this concern was uncertainty over the appropriate negotiating strategy for a company like Airwick. Finally, assuming that Airwick could be acquired for the right price, it was not clear how this multinational business would fit into the geographic-based management structure of the CIBA-GEIGY group of companies.

These questions had special importance in the spring of 1974, since CIBA-GEIGY was just completing a tender offer for a majority of the shares of a hybrid seed company and was holding discussions with two other acquisition candidates complementing other areas of the corporation's business. While these diversifying acquisitions, if consummated, would not eliminate the possibility of further acquisitions, there was concern that postmerger problems would consume more top management time and corporate funds than currently expected.

Household products. Prior to the merger of CIBA and GEIGY, policy in both companies vacillated with respect to consumer products. After the merger, the group decided that consumer product markets should be considered an appropriate area for growth. Household products, lawn and garden products, and toiletries were targeted as prime opportunity areas. However, each local subsidiary had the freedom to decide for itself whether or not it was worthwhile entering any of these consumer market segments.

The potential acquisition of Airwick posed a "fish or cut bait" decision for CIBA-GEIGY with respect to consumer products, in general, and household products in particular. In fact, CIBA-GEIGY was seriously considering divesting the small Madison Laboratories Division which was having a great deal of difficulty selling toiletries, developed for the most part in Switzerland, in the U.S. market. Madison had annual sales in the $8–$9 million range and was only breaking even at the contribution to corporate overhead level. By the time the Airwick acquisition study was presented, CIBA-GEIGY had already held three sets of discussions with companies interested in acquiring Madison.

In analyzing both Madison and Airwick, an important question was whether research, product quality, and strong patents—CIBA-GEIGY's special strengths—were relevant to its long-run success. Superficial features often played an important role in such products and

this could offend the Swiss business philosophy. Consideration had to be given to the fact that advertising budgets could reduce profits for several years and that this, too, might not be satisfactory. Finally, there was only limited management experience in the consumer products area. At the same time, the Swiss parent had a small research program going in the household odor area and several European subsidiaries were participants in the institutional cleaning market.

Assessment of Airwick. MacKinnon and the acquisitions task force agreed with the Airwick task force that the institutional segment of Airwick had good potential and might be able to provide an outlet for some CIBA-GEIGY products handled by the agricultural division. On the other hand, the domestic consumer segment was an area of concern. Airwick's sales projections seemed unrealistically optimistic, but there was no way of revising these estimates on any scientific basis under the current press of events. Furthermore, it was suspected that Airwick might have to develop a catch-up advertising program since the company had fallen behind the competition in this area. Finally, the softening U.S. economy was not an encouraging environment for nonessential consumer goods.

Even the attractive European market for Airwick's consumer products posed a troublesome dilemma. What would Airwick gain if it built the market abroad, only to see the big consumer products companies in Europe buying into the new market with "me-too" products at a lower price?

Airwick's acquatic operations were another concern. While they represented one-third of Airwick Industries' total sales, CIBA-GEIGY had already decided on its own against going into this business. Both the president and chairman of Airwick had indicated to MacKinnon that neither a spin-off of this business to Airwick shareholders nor a straight sale of the division would be acceptable to them. Since they controlled over 30% of the outstanding shares between them, their wishes in the matter had to be considered carefully.

Valuation and negotiating strategy. The valuation issue was complicated not only by the deteriorating competitive position of Airwick's consumer brands division, but also by the difficulty in establishing a value for discrete parts of Airwick's business. Joint use of assets by the several divisions made asset-based analysis highly tenuous.

Recent movement in Airwick's stock price complicated both the valuation and negotiating tasks. As a practical fact, MacKinnon knew that CIBA-GEIGY would have to pay Airwick shareholders a premium over market value, but on what basis should this premium be figured? During the first quarter of 1974 the price of Airwick's shares held steady around the $8 level. As both parties were preparing to enter final negotiations, however, the price of Airwick's shares ran up to about $10 per share. Since Airwick was being actively courted by other potential acquirers, MacKinnon suspected that news of potential merger negotiations had somehow leaked to the financial community. The resulting question was what price would be required for the Airwick shareholders to feel they were receiving a substantial enough premium to support the acquisition? *Table E* shows the price range of Airwick's common stock through the second quarter of 1974. It also shows the number of unexercised options held by Airwick's officers and directors.

Table E
Price Range of Airwick's Common Stock

	High	*Low*
1972		
First quarter	$14.28	$9.12
Second quarter	21.88	13.78
Third quarter	24.81	17.50
Fourth quarter	23.38	18.68
1973		
First quarter	23.63	14.13
Second quarter	19.38	13.38
Third quarter	24.38	15.88
Fourth quarter	23.88	8.50
1974		
First quarter	11.00	6.50
Second quarter	13.00	6.00
Unexercised Options, All Directors and Officers, April 4, 1974		
Number of shares		97,300
Average option price		$6.89

Note: Adjusted to reflect a three-for-two stock split in May 1972, and a two-for-one stock split in February 1973.

While CIBA-GEIGY had decided that a tender-offer would be the most appropriate acquisition vehicle in this case, several management issues had to be resolved before such an offer could be made to the public. Airwick had a stock option and bonus program for its management employees while CIBA-GEIGY did not have stock options. There was thus a question about how to handle the stock options and whether or not to continue the Airwick bonus program if Airwick merged with CIBA-GEIGY. In addition, since CIBA-GEIGY had never written management contracts with its key employees, a decision was needed on what to do if such contracts were requested during the negotiations.

Organizational issues. A final question of concern was how to integrate Airwick into the CIBA-GEIGY management structure, if it was acquired. Under current arrangements, consumer product companies normally reported to country-based subsidiaries of CIBA-GEIGY Limited. Thus, consumer product companies in France reported to CIBA-GEIGY (France). This arrangement presented problems in the Airwick case, since the company had a major international segment operated from England. If current patterns were followed, Airkem (Export), Ltd., would have to be separated to some extent from the U.S. operations. This arrangement, it was feared, might lead to a decreased commitment on the part of Airwick's domestic managers to international development.

An alternate arrangement would be for CIBA-GEIGY to assume direct responsibility for Airwick's worldwide operations. This posed difficult questions, too. How could you take direct business responsibility away from France for Airwick's French business when they had done such a good job for Airwick on a distributor basis in the past? What kind of commitment to Airwick products could you expect from French managers if everything was directed from New York?

A final alternative was to have Airwick report directly to Switzerland. This plan, however, would involve a major break in CIBA-GEIGY's worldwide operating philosophy.

Exhibit 1
Airwick Industries and Subsidiaries
Consolidated Statement of Earnings

	Year ended December 31				
	1969	1970	1971	1972	1973
Sales and other revenue					
Net sales	$12,376,000	$15,724,000	$21,855,000	$27,307,000	$33,024,000
Other revenue	205,000	203,000	312,000	466,000	772,000
	12,581,000	15,927,000	22,167,000	27,773,000	33,796,000
Costs and other charges					
Cost of sales	5,120,000	6,755,000	9,495,000	11,236,000	13,778,000
Selling and administrative expenses	5,934,000	7,674,000	9,937,000	12,600,000	14,860,000
Interest expense					
Long-term debt	53,000	45,000	46,000	47,000	59,000
Other	23,000	61,000	24,000	4,000	45,000
Miscellaneous charges	42,000	40,000	35,000	98,000	71,000
	11,172,000	14,575,000	19,537,000	23,985,000	28,813,000
Earnings before income taxes	1,409,000	1,352,000	2,630,000	3,788,000	4,983,000
Income taxes	702,000	610,000	1,195,000	1,677,000	2,300,000
NET EARNINGS	$ 707,000	$ 742,000	$ 1,435,000	$ 2,111,000	$ 2,683,000
Average number of common shares outstanding (Note 1)	3,062,344	3,070,512	3,204,658	3,399,252	3,457,290
Earnings per share of common stock (Note 1)	$.23	$.24	$.45	$.62	$.78
Cash dividends declared on common stock (Note 2)	$.08	$.08	$.09	$.11	$.15

NOTES:

1. Earnings per share of common stock have been computed on the weighted average number of common shares outstanding in each year, after giving retroactive effect to the 3 for 2 stock split in 1972 and the 2 for 1 stock split and the reclassification on a share for share basis of Class A and Class B common stock for a single class of common stock in 1973 and retroactive adjustment for shares issued in 1972 in connection with the acquisition of King-Kratz Corporation in a pooling of interests (Note A-3 to Notes to Consolidated Financial Statements). Shares issuable under employee stock options and warrants are excluded from the weighted average number of shares in determining earnings per share on the basis that the dilutive effect is less than 3%.

2. Dividends per share of common stock have been computed on the number of shares outstanding at time of declaration, after giving retroactive effect to the changes described in Note 1. The pooled company paid no dividends.

Source: Company document

Exhibit 2
Airwick Industries and Subsidiaries
Consolidated Balance Sheet, Year Ended December 31

ASSETS	1973	1972
Current Assets		
Cash	$ 1,770,000	$ 1,683,000
Short-term investments — at cost which approximates market value		993,000
Customers' receivables	3,747,000	3,101,000
Other receivables	137,000	61,000
Inventories (Note A-4)		
Finished goods	2,379,000	1,313,000
Work in process	393,000	180,000
Raw materials	1,980,000	1,185,000
	4,752,000	2,678,000
Prepayments, advances and other items	515,000	477,000
Total current assets	10,921,000	8,993,000
Property, plant and equipment — at cost, less accumulated depreciation and amortization (Notes A-5 and D)	5,187,000	3,038,000
Other assets		
Prepayments of obligations to former distributor, less amortization of $652,000 in 1973 and $569,000 in 1972 (Note A-6)	351,000	433,000
Patents, trademarks and other, less amortization of $371,000 in 1973 and $334,000 in 1972 (Note A-6)	188,000	182,000
Prepaid pension costs (Note A-7)	470,000	500,000
Deferred charges and other	519,000	320,000
	1,528,000	1,435,000
	$17,636,000	$13,466,000

LIABILITIES	1973	1972
Current Liabilities		
Notes payable — bank (Note G)	$ 870,000	$
Current maturities of long-term debt (Note E)	69,000	92,000
Accounts payable	2,363,000	1,777,000
Accrued compensation and other expenses	759,000	538,000
Income taxes (Notes A-10 and F)	1,238,000	1,033,000
Total current liabilities	5,299,000	3,440,000
Long-term Debt (Note E)	511,000	609,000
Deferred income taxes (Notes A-9 and F)	189,000	11,000
Commitments (Note G)		
Stockholders' equity (Notes H and I)		
Capital stock		
Preferred — authorized, 100,000 shares of $1 par value, none issued	—	—
Common stock, par value $.05 — authorized, 6,000,000 shares; issued and outstanding, 3,464,942 shares in 1973 and 3,447,482 shares in 1972	173,000	172,000
Additional contributed capital	3,510,000	3,444,000
Retained earnings	7,954,000	5,790,000
	11,637,000	9,406,000
	$17,636,000	$13,466,000

The accompanying notes are an integral part of this statement

Exhibit 2 (continued)
Airwick Industries and Subsidiaries
Notes to Consolidated Financial Statements

NOTE A — SUMMARY OF ACCOUNTING POLICIES

A summary of the significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements follows:

1. PRINCIPLES OF CONSOLIDATION
The consolidated financial statements include the accounts of the wholly-owned domestic and foreign subsidiaries and the accounts of King-Kratz Corporation acquired in 1972 in a pooling of interests transaction. Material intercompany amounts and transactions were eliminated in consolidation.

2. FOREIGN CURRENCY TRANSLATION
Current assets and current liabilities are translated at the rate of exchange in effect at the close of the period. Long-term assets are translated at the rates in effect at the dates those assets were acquired, and long-term liabilities are translated at the rates in effect at the dates these obligations were incurred. Exchange adjustments are charged or credited to income. The exchange adjustments resulted in an exchange gain of $36,000 for 1973 and an exchange loss of $52,000 for 1972. Revenue and expense accounts are translated at the average of exchange rates which were in effect during the year, except for depreciation and amortization which are translated at the rates of exchange which were in effect when the respective assets were acquired.

3. POOLING OF INTERESTS
On October 31, 1972, the Company acquired all of the issued and outstanding shares of King-Kratz Corporation by issuing 81,586 shares of its common stock.

4. INVENTORIES
Inventories are stated at the lower of cost or market; cost is determined using the first-in, first-out method.

5. PROPERTY, PLANT AND EQUIPMENT
Depreciation and amortization are provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. The buildings are being depreciated on the double-declining balance and straight-line methods over a 45-year period. Other depreciable assets are depreciated generally on the straight-line method over periods ranging from two to twenty years. Leasehold improvements are amortized over the lives of the leases or the service lives of the improvements, whichever is shorter, on the straight-line basis.

   The Company capitalizes, for both financial reporting and tax purposes, leased equipment where the terms of the lease result in the creation of a material equity in the property accruing to the Company. The consolidated balance sheet reflects all such leased manufacturing equipment as assets and long-term obligations.

6. AMORTIZATION POLICIES
Payments to a former distributor are being amortized on the straight-line basis to the expiration date of the agreement.

   The cost of marketing rights to a line of products is being amortized on the straight-line basis over the terms of the underlying agreements.

   The cost of patents and trademarks are capitalized and amortized to operations over their statutory lives. Amortization is computed on the straight-line method.

   Goodwill is amortized on a straight-line basis over a period of five years.

7. PENSION PLANS
The Company has a pension plan covering substantially all of its full-time employees. It is the Company's policy to fund normal pension cost. A United Kingdom subsidiary also has a pension plan for its employees. As of January 1, 1972, the Company amended its pension plan which resulted in increased benefits to its employees. As a result of the amended plan, the Company has incurred past service cost which it has funded and is amortizing over a ten-year period. The changes in the pension plan had no significant effect on net earnings for 1972. The pension charges to income amounted to $152,000 each in 1973 and 1972.

8. RESEARCH AND DEVELOPMENT
Costs incurred in the development of new products are charged to income as incurred.

9. DEFERRED INCOME TAXES
Deferred income tax expense results from timing differences in the recognition of revenue and expense for tax and financial statement purposes.

10. INVESTMENT TAX CREDITS
Investment tax credits are accounted for by the "flow-through" method. Under this method, credits are recognized as a reduction of income tax expense in the year the assets giving rise to the credit are placed in service.

NOTE B — ACQUISITION

On January 31, 1974, the Company acquired approximately 90% of the issued and outstanding common stock of Seablue Corporation, a corporation engaged in the manufacture, distribution and sale of swimming pool supplies and equipment for approximately $3,600,000 in cash in a transaction to be accounted for as a purchase. Further, the Company will offer to purchase the remaining 10% of the issued and outstanding common stock from the minority stockholders at the same terms offered the principal stockholders. If all of the remaining stockholders accept the offer, the Company's total purchase price will amount to approximately $4,000,000.

NOTE C — FOREIGN OPERATIONS

The following is a summary of the accounts of the foreign subsidiaries at December 31, 1973 and 1972.

	1973	1972
Current assets	$3,698,000	$3,021,000
Current liabilities	1,862,000	1,294,000
	1,836,000	1,727,000
Fixed assets, less accumulated depreciation and amortization	109,000	86,000
Other assets	9,000	9,000
	1,954,000	1,822,000
Less		
Amounts due to parent company — net	221,000	160,000
Long-term debt	195,000	226,000
Deferred income taxes	3,000	
	419,000	386,000
Net assets	$1,535,000	$1,436,000

Exhibit 2 (continued)

The cumulative amount of undistributed earnings of foreign subsidiaries on which the parent company has not recognized United States income taxes amounted to approximately $1,-500,000 and $1,400,000 at December 31, 1973 and 1972, respectively. During the year, the Company received dividends amounting to $1,297,000 from foreign subsidiaries.

It is the Company's practice to provide currently for taxes which will be payable upon remittance of foreign earnings to the parent company, based upon estimates of the amounts to be received in dividends.

NOTE D — PROPERTY, PLANT AND EQUIPMENT

These assets are summarized as follows:

	1973	1972
Land	$ 400,000	$ 221,000
Buildings and improvements	2,365,000	1,537,000
Machinery and equipment	3,705,000	2,238,000
Machinery under lease option agreement	202,000	202,000
Leasehold improvements	211,000	217,000
Construction in progress	68,000	
	6,951,000	4,415,000
Less accumulated depreciation and amortization	1,764,000	1,377,000
	$5,187,000	$3,038,000

NOTE E — LONG-TERM DEBT

This item comprises the following obligations:

	1973	1972
Mortgage loan — 5⅞%, payable in monthly installments of $2,125 to 1985	$306,000	$332,000
Note payable — bank (interest rate ½ of 1% over minimum lending rate) repayable in installments of $50,000 in 1975 and $145,000 in 1976	195,000	246,000
Other	117,000	182,000
	618,000	760,000
Less unamortized discount	(38,000)	(59,000)
	580,000	701,000
Less current maturities	69,000	92,000
	$511,000	$609,000

The aggregate maturities of long-term debt are summarized as follows:

	1973	1972
1973	$	$121,000
1974	105,000	128,000
1975	107,000	61,000
1976	177,000	221,000
1977	25,000	25,000
1978	25,000	
Subsequent	179,000	204,000
	$618,000	$760,000

NOTE F — INCOME TAXES

The Federal income tax returns of the parent company subsequent to 1969 are subject to review by the Internal Revenue Service. Income tax expense for the year ended December 31, 1973 is made up of the following components:

		Foreign		
	U.S. Federal	Income tax	Taxes withheld at source	Total
Current tax expense	$1,125,000	$829,000	$168,000	$2,122,000
Deferred tax expense	175,000	3,000		178,000
	$1,300,000	$832,000	$168,000	$2,300,000

Income tax expense for the year ended December 31, 1972 is made up of the following components:

	U.S. Federal	Foreign	Total
Current tax expense	$1,081,000	$596,000	$1,677,000

Deferred tax expense results from timing differences in the recognition of revenue and expense for tax and financial statement purposes. The sources of these differences in 1973 and the tax effect of each were as follows:

Excess of tax over book depreciation	$ 66,000
Computer development costs expensed on tax return and deferred on books	59,000
Convention expenses expensed on tax return and deferred on books	41,000
Other timing differences	12,000
	$178,000

NOTE G — COMMITMENTS

The minimum rental commitments under all noncancellable leases are as follows:

	1974	1975	1976
Plant facilities	$111,000	$107,000	$ 99,000
Equipment	88,000	87,000	87,000
Office facilities	142,000	119,000	112,000
	$341,000	$313,000	$298,000

	1977	1978	1979 and beyond
Plant facilities	$ 88,000	$ 82,000	$303,000
Equipment	53,000		
Office facilities	102,000	94,000	77,000
	$243,000	$176,000	$380,000

Some of the leases require the Company to pay for maintenance, taxes and insurance. Total rental expense amounted to $454,000 and $308,000 for 1973 and 1972, respectively.

At December 31, 1973, the Company had a credit line with a bank amounting to $2,000,000. The related short-term debt outstanding was $870,000 at an interest rate of 9¾% per annum. During January 1974, the credit line was increased to $6,000,000. The credit line can be withdrawn at the bank's option. There were no compensating balance arrangements at December 31, 1973 under the line of credit. However, there is an informal understanding that the Company maintain a principal operating account with the bank.

Exhibit 2 (continued)

NOTE H — STOCK OPTIONS AND WARRANTS

Under qualified stock option plans as approved by the stockholders on May 25, 1966 and April 24, 1968, options may be granted to officers and key employees of the parent company within ten years to purchase an aggregate of 120,000 shares of common stock under the 1966 plan and 90,000 shares of common stock under the 1968 plan. The option price must be not less than the fair market value of the stock on the date of grant. Options are exercisable after two years from the date of grant but not later than five years from such date.

Under a nonqualified stock option plan as approved by the stockholders on April 26, 1972, options may be granted to employees of the Company within ten years to purchase an aggregate of 198,000 shares of common stock. The option price must not be less than the fair market value of the stock on the date of the grant. Options are exercisable two years from the date of the grant but not later then ten years from such date.

Changes during 1973 under the plans were as follows:

	Shares		
	Reserved	Granted	Available
Balance—January 1, 1973	263,600	88,500	175,100
Granted		61,800	(61,800)
Cancelled		(5,500)	5,500
Exercised	(17,460)	(17,460)	
Balance—December 31, 1973	246,140	127,340	118,800
Option price range		$4.813-$21.25	
Exercisable at December 31, 1973		30,540	

Changes during the 1972 under the plans were as follows:

	Shares		
	Reserved	Granted	Available
Balance—January 1, 1972	131,100	115,500	15,600
1972 plan	198,000		198,000
Granted		40,500	(40,500)
Cancelled		(6,000)	6,000
Exercised	(61,500)	(61,500)	
Balance—December 31, 1972	267,600	88,500	179,100
Option price range		$4.813-$19.50	
Exercisable at December 31, 1972		45,000	

NOTE I — CAPITAL STOCK

On April 26, 1972, the stockholders authorized the following changes in the capital structure:

(a) An increase in the authorized Class A common stock from 400,000 shares ($.05 par value) to 600,000 shares ($.05 par value).

(b) An increase in the authorized Class B common stock from 1,600,000 shares ($.05 par value) to 2,400,000 shares ($.05 par value).

(c) Both the Class A and Class B common stock outstanding were split on a 3 for 2 basis.

On January 24, 1973, the stockholders authorized the following changes in the capital structure:

(a) An increase in the authorized Class A common stock from 600,000 shares ($.05 par value) to 1,200,000 shares ($.05 par value).

(b) An increase in the authorized Class B common stock from 2,400,000 shares ($.05 par value) to 4,800,000 shares ($.05 par value).

(c) Both the Class A and Class B common stock outstanding were split on a 2 for 1 basis.

(d) Class A and Class B common stock were reclassified on a share for share basis for a single class of common stock.

Accordingly, retroactive effect has been given to the financial statements for the Company's 2 for 1 split in 1973 and for the reclassification on a share for share basis of Class A and Class B common stock into a single class of common stock.

To the Stockholders
Airwick Industries, Inc.

We have examined the consolidated balance sheet of Airwick Industries, Inc. and Subsidiaries as of December 31, 1973 and 1972, and the related consolidated statements of earnings, retained earnings, additional contributed capital, and changes in financial position for the years then ended. our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We have received reports of other auditors with respect to their examination of certain of the consolidated foreign subsidiaries whose assets and revenue constitute 19.9% and 14.9%, respectively, in 1973 and 20.8% and 13.8%, respectively, in 1972 of the corresponding consolidated totals. Insofar as our opinion expressed herein relates to amounts for certain of the foreign subsidiaries, it is based solely on the aforementioned reports of the other auditors.

In our opinion, based upon our examination and the aforementioned reports of other auditors, the consolidated financial statements referred to above present fairly the consolidated financial position of Airwick Industries, Inc. and Subsidiaries at December 31, 1973 and 1972, and the consolidated results of their operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Alexander Grant & Company
New York, New York
January 31, 1974

Source: Company document

Exhibit 3
Seablue Corporation
Consolidated Statement of Income and Expenses

	Year Ended October 31, 1971	Year Ended October 31, 1972	Year Ended October 31, 1973	Two Months Ended December 31, 1973 (unaudited)
Sales	$5,431,475	$7,571,283	$9,575,479	$ 797,508
Less, Cost of Goods Sold	4,081,843	5,702,997	7,155,008	651,030
Gross Profit	1,349,632	1,868,286	2,420,471	146,478
Less, Selling Expenses	264,288	360,806	446,611	52,919
Selling Profit	1,085,344	1,507,480	1,973,860	93,559
Less, General and Administrative Expenses	777,843	929,759	1,238,289	163,749
Operating Profit (Loss)	307,501	577,721	735,571	(70,190)
Add, Other Income:				
Discounts Earned	48,077	67,368	83,799	6,844
Interest Income	—	4,283	124	89
Rental Income	—	917	200	—
Currency Exchange	—	—	14,148	—
Miscellaneous Income	596	2,037	12,959	2,438
	48,673	74,605	111,230	9,371
Net Profit (Loss) Before Other Deductions	356,174	652,326	846,801	(60,819)
Less, Other Deductions				
Discounts Allowed	52,717	71,701	105,206	10,013
Interest Expense	45,185	63,349	129,531	19,866
State Income Taxes	5,210	6,764	12,209	—
Rent Expense	—	64	295	—
Currency Exchange	—	(50)	—	(83)
Miscellaneous Expense	—	—	(1,795)	2,048
	103,112	141,828	245,446	31,844
Net Profit (Loss) Before Federal Income Taxes and Extraordinary Charges	253,062	510,498	601,355	(92,663)
Less, Federal Income Taxes—Current	110,921	236,246	237,937	(44,989)
Federal Income Taxes—Deferred—	—	—	15,688	1,039
	110,921	236,246	253,625	(43,950)
Net Profit (Loss) Before Extraordinary Charges	142,141	274,252	347,730	(48,713)
Less, Extraordinary Charges (Write-off of worthless investment)	6,000	—	—	—
Net Income (Loss)	$ 136,141	$ 274,252	$ 347,730	$ (48,713)
Net Income (Loss) per Share:				
Before Extraordinary Charges	$2.41	$4.65	$5.89	$(.83)
Less, Extraordinary Charges	.10	—	—	—
	$2.31	$4.65	$5.89	$(.83)

Source: Company document

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9

WHARTON REPROGRAPHICS

THE JIM HEAVNER STORY (A)

Sitting across the table from Roger Jennings, executive vice president of The Village Companies, I could not help noticing that he seemed much older and grayer than I remembered. As he smiled the corners of his eyes formed deep crevices that weren't there a decade earlier when The Village Companies was just WCHL, a local radio station. His face seemed to reveal all the experiences which had transformed this small radio station into a multi-divisional, geographically dispersed company (Exhibit 1).

Roger was one of the first persons hired by Jim Heavner. Starting as a sales person for the radio station, he had emerged as the most solid citizen in what was to become Heavner's core group. In the space of less than a decade, Roger had moved through the roles of sales manager, division manager, and general manager of the company's first major out-of-town acquisition, and now he was back in the home office having tendered his resignation. He seemed much wiser now and he looked tired.[1] At the ripe age of 36, Roger was through with The Village Companies and with Jim Heavner. He was going out on his own.

The Birth of WCHL

The Village Broadcasting Company, or what local citizens and university students knew as simply "WCHL," was formed in Chapel Hill, North Carolina in 1953 by Sandy McClamroch and a partner. It began as a small AM "daytimer" (it went on the air at daybreak and off again at sunset) and was situated in a community known to many as "the village" and to more than a few as "the southern part of Heaven."

Despite dramatic growth, Chapel Hill retains its village atmosphere. The almost complete merger of town and gown (the University of North Carolina is located in the village) is one reason for its enduring character. Growth in the community was caused not only by enrollment increases at the University, but also by the desirability of living in the village perceived by nearby Duke University faculty and by scientists, executives and other professionals drawn to the area by work assignments in "The Research Triangle Park" (a large tract of land joining the cities of Chapel Hill, Durham and Raleigh and zoned for corporate headquarters and research laboratories).

Recent growth statistics for Chapel Hill reveal the expansion in size and affluence of WCHL's radio audience. For instance, the number of households

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[1] Observation of the casewriter

This case was prepared by Associate Professor Robert H. Miles as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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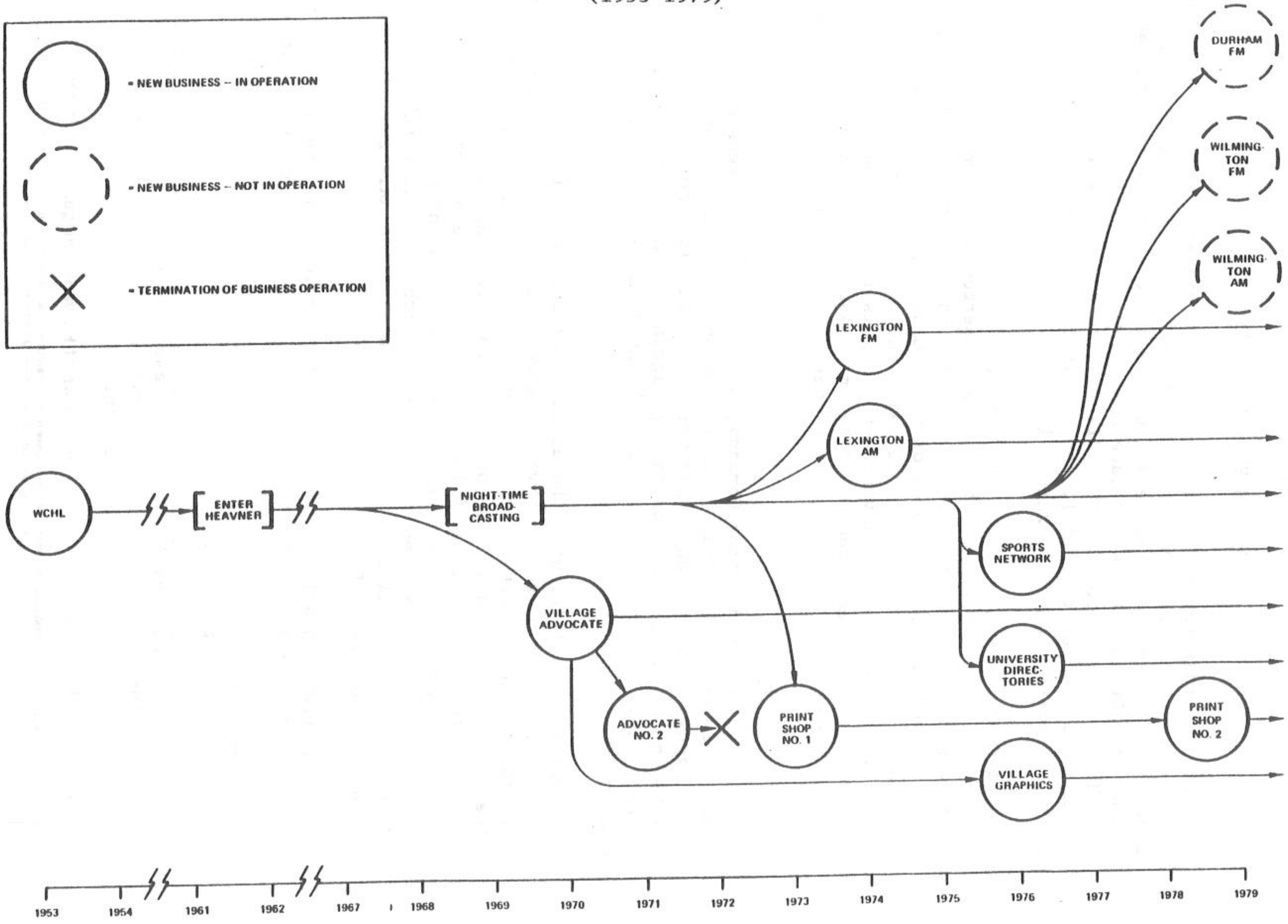
Exhibit 1

THE JIM HEAVNER STORY (A)

The Evolution of The Village Companies:
(1953-1979)



increased by 125% from 1960 to 1978. During the same period, permanent residents increased by 180% and student enrollment, by 136%. Influenced in part by the relocation into Chapel Hill of a major Southeastern bank, bank deposits soared by 15,352% between 1960 and 1978. But this growth was managed carefully by an active town government that, for example, placed severe limits on commercial developments like apartment complexes and high-rise projects (only the bell tower at UNC would extend above the trees).

It is not clear, however, that Sandy and his partner fully appreciated the bonanza that was to come when they made the WCHL purchase decision. What is known is that Sandy's father was a professor at UNC, where Sandy had graduated with a degree in Commerce, and that his roots in Chapel Hill were deep. So when he learned of the opportunity to start this little "daytimer," for approximately $20,000, Sandy left his job selling farm equipment and went into business in the village.

In time, WCHL began to turn a small profit and Sandy bought out his partner. Sandy had many community interests and by then he had become active in local affairs and politics. He also was involved in other real estate and business ventures that profited from Chapel Hill's explosive growth. But things at WCHL did not really take off until Sandy decided to hire Jim Heavner, then in his early twenties, to handle the day-to-day activities of selling and programming.

Jim and the Mayor

Jim Heavner came from a small town in rural North Carolina. He recalls that at the age of 10 he was pushed by his parents to develop writing skills and to enter "speech contests." And he often refers to the series of "marvelous accidents" that he believed had been an important part of his exciting and rewarding career. For example, Jim had broken his arm while trying out for a junior varsity basketball team in high school. As a consequence of not being able to play, he began scoring the games and announcing the plays over the P.A. system. These activities led him to write sports stories for a local newspaper.

By the time Jim reached the University at Chapel Hill, he was an experienced announcer and he had been involved in all aspects of radio programming and copy writing. As Jim recalls, *"When I hit Chapel Hill I was just enough ahead of the pack to get a job as an announcer at WUNC (the University's radio station)."* By the end of his first year, Jim was working part time at WCHL. He left six months later to take a job as an announcer at a nearby television station. That led to a central role as sports announcer in a weekly television bowling show which lasted about a year. As Jim recalls,

> *... that was an incredible experience ... It meant that for 60 minutes every Sunday afternoon the only voice that was heard with the exception of one break for a national commercial was mine.*

As the bowling show was winding down, Sandy phoned to see if Jim would be interested in returning to WCHL. Sandy, who is 15 years Jim's senior, provided

this account of his decision to hire young Heavner:

All I can remember is that I was going to be Mayor [of Chapel Hill] and that Ty Boyd [WCHL's only radio personality] was going to leave [to become the "morning man" at a much larger station in Charlotte]. Jim had worked for us as an announcer while he was in school and had left to do a bowling show on TV. And in just the short experience where I had gotten to know him, he was the only one I knew who had the capabilities, in my estimation, to take over the selling job <u>and</u> the programming job. I had no real knowledge of the programming myself. I had been selling since the beginning of the station and watching the dollars primarily ... Even back then, at 20 years old, you could tell that Jim could sell ...

From Jim's recollection, the offer from Sandy came something like this:

Sandy called and asked me to come over. (I already had the news that Ty was leaving.) I shot down the boulevard and wandered into the little concrete block building at the foot of the Hill which contained the radio station. And Sandy began by saying "You know, Ty is going to Charlotte and I'd like you to take his job." I said, "Fine Sandy, I'll be here in two weeks." And he says, "Well, wait a minute. I want to tell you how much you're going to make. Let me tell you about the job. Let me tell you what your duties are, your responsibilities ..." And I said, "Sandy, if it's Ty's job and if you're my boss, that will be fair." He went on to say "Well we're going to pay you $125 a week." And then he said, "Ty has done a great job here. He has built the radio station up to the point that selling now is," and I am confident that I'm quoting, "it's pretty much an order taking job now." ... I got a car. It was a 1949 Ford whose axle was going to break within the next 90 days.

So all of those things were just marvelous, marvelous, marvelous. It may be one of the last times of my life when I experienced totally unexpurgated joy at the prospect of something new. I knew I could work for Sandy. I knew that I liked him. I think I had an intuitive sense that he was supportive and interested in outcomes and that I was very active and interested in creating the solutions; and I sensed that we had a match.

Jim also recalls that Sandy said, *"Someday, if this thing goes well, if you want to stay here, and if you do a good job, I might let you buy some stock in it."* Jim's reaction: *"Mmmm ... Heavy. That was a heavy idea."* So, Jim cancelled plans to continue studies at the University. At the age of 20, he felt his was "a rare opportunity" and everyone he consulted tended to agree. Even before he assumed his new duties, however, another of his "marvelous accidents" occurred:

Sure enough, Sandy was elected Mayor about ten days before I came to work. Being a Mayor was something Sandy liked a lot. So

he started spending a lot of time at Town Hall. The town manager retired and they had to go through the laborious process of hiring his replacement. And then, if you remember, in 1960, 61, 62, and 63, social issues began heating up. Kennedy was elected in 1960. We began to have the crisis of rising expectations and the civil rights advocates began taking to the streets somewhere in the early 1960s, and Chapel Hill was highly vulnerable to this kind of thing.

These events took Sandy out of the day-to-day operations of the radio station. He remained in the office of the Mayor for eight years of the most tumultuous times the village had ever witnessed.

Building WCHL

Jim Heavner described what he found when he arrived for work at WCHL:

WCHL was what I would call a single-cell amoeba; a very simple operation. I was sales manager, program director and "morning man" ... The early work was principally week to week. We had to no forecasting system and, of course, I had no formal business training ... We didn't draw a budget for seven or eight years. Advertising spots were being sold for $1.00 and total annual sales approximated $60,000. Most of the time I would just ask Sandy how things were going and if our collections were running behind he would say, "Not so good. We need to collect some money;" and I would say, "Oh? Who owes us?" And he would tell me and I would hit the street and try to collect some money. Because Sandy was so highly respected, I would attempt to delegate that to him. But Sandy really did not like to carry unpleasant news; so he was not a super collector. Interestingly enough, however, when the bank balance got low enough, Sandy became a great collector. He had a really clear picture. He had a feeling that if you've got more money in the bank than I have, then dammit you ought to pay me. But if I'm sitting here with more money in the bank than you have, and you owe me some, then I won't bug you ... It was my observation that Sandy could really be tough if he wanted.

Out of this modest beginning, Heavner began to fashion a business strategy that would eventually lead to local respectability and financial success for WCHL. His early priorities were to build up sales and improve programming. His little station fortunately operated in an "unrated" market, where listenership statistics were not available to customers. Nevertheless, the broadcasting power of WCHL barely reached the fringes of Chapel Hill, while bigger stations in nearby Durham and Raleigh were powerful enough to reach the village audience.

Heavner's overall strategy was, first, to cater to village interests and politics in programming and, second, to demonstrate that WCHL could serve Chapel Hill clients better than the competition.

On the sales side, Heavner wanted local retailers and other business

people to feel that WCHL was working hard for them. He viewed sales people at the larger stations as account managers and order takers. In many cases they managed longer term accounts with regional and national advertisers, who often provided the copy they wanted on the air. They also tended to view local accounts as fillers.

He built his marketing approach around the slogan, "WCHL Works," and he hoped to make the double meaning obvious to his clients. Early on, Jim developed a quarter-hour diary in order to help him maximize his contact with clients. He tailored creative copy to the particular image of each customer, often taking different recordings of an advertising spot to customers for preview before selecting the one to broadcast. He sent out mailers to WCHL clients extolling the virtues of WCHL staff or reporting WCHL's involvement in community projects, *"... a lot of shirtsleeves pictures."* With time, the strategy paid off and sales began to mount.

On the programming side, Jim gradually evolved music format changes to cater to the growing student and young adult population. More important than these programming changes were his innovations geared toward becoming more closely identified with the community. Political debates involving town matters were frequently aired on WCHL. The station became involved in numerous community events like "Hot Diggity Day," the "Halloween Carnival," and "Apple Chill Fair." They were all big affairs in the life of the village and soon they became institutionalized in the town culture and calendar. Thus, on the positive side, Heavner observed that, *"The radio station had done a good job of establishing itself as a worthy community citizen; but we turned everybody over to our competitors at sundown because we had to sign off."*

So, Heavner emerged from this first phase in the development of WCHL with both an expanded and stable local client base and the respect and identification with the radio station of this unusual community. Moreover, Jim felt that all this hard work together with the good vibes from being a part of the community had a very positive effect of the morale and motivation of his staff.

There was personal reinforcement for Jim too. Not only did he emerge as a highly visible young man on the move, but the national Radio Advertising Bureau picked up his act. Billing Jim as "the world's largest one-man sales staff," RAB invited Heavner, then 25, to speak at their national management conferences. As Jim explains, *"There were a lot of little ideas coming out of WCHL... we were an idea station."* But a comment made repeatedly from these audiences eventually triggered the next stage in the development of both Jim Heavner and WCHL:

> *... they would nearly always say, "If you're so smart, why aren't you hiring some other guy to be doing this with you? Why are you a one-man sales staff?" My answer came to be, "I will hire another salesperson when the station's resources are enough that I can afford someone who has the potential to be more competent than I am. I will teach him all I know and expect him to bring his own intellectual resources to it, and then I will learn from him and we*

will move ahead together." And I was really committed to that idea.

By now, Sandy had begun to let Jim participate more and more in the ownership of the company. Moreover, Jim had always recieved both an increase in base pay and a bonus each year:

> *... each year Sandy would give me a bonus check which, in every case, I felt was more than fair. I never felt underpaid. It was always just a little more than I thought I had coming and that was a nice feeling. And to the extent that we can do that today in our bonus plans, we attempt to execute that now. That takes some careful management.*

Roger Jennings and the Developing Salesforce Concepts

By 1967, the resources of the company had grown to the point that Heavner had already made a bad mistake in hiring his first salesperson. Jim remembers that, *"I didn't want to have a typical small-town radio time peddler working for me."* So he hired a young banker who had been President of the Durham Jaycees and local Man of the Year. *"I failed to comprehend, however, how difficult it would be for someone without a media background ... and someone who couldn't write."* One day, about three months later, the guy called from a bank in Virginia and informed Jim that he wouldn't be returning to WCHL.

At about that time, Heavner remembered a conversation he had had with Roger Jennings, a graduate student at UNC in Radio, Television and Motion Pictures. Roger had come to him, offering to "take over the thirty worst accounts in the radio station and sell them" to demonstrate that he was worthy of a position at WCHL. When asked what his goals were, Roger told Jim that he eventually wanted to be an ETV director and hoped to be earning about $15,000 by the time he was 35.

> *Not a bad strategy. I had thanked him but said, "No thanks." But I remembered that Roger had written me a couple of letters. His syntax was pretty good and he had paragraphs that seemed to flow with nice transitional phrases. I remembered that. And I learned that he had finished his course work for his masters and was working as director at the University's television station.*

Roger was hired, with Jim's promise of "a chance to grow," and this event marked the beginning of a long, close relationship. As Jim recalls,

> *I'd had that failure and Roger, by God, was not gonna fail. He and I got in the trenches together. I was there and he was there, night after night after night.*

Roger was carefully coached in all aspects of selling that Jim had perfected during his first half decade at WCHL. But Heavner's approach to Roger's development extended beyond training. *"Something I believe deeply,"* said

Heavner, *"is that of equal value to the training is the commitment the trainer must make to the trainee for his of her success. The coach has to be willing to say I'm going to win or lose with you."*

Roger described those early months at WCHL as follows:

> *There was a great feeling of community in the place because it was so small; and, certainly, Jim and I had a very personal kind of business relationship -- a very one-on-one kind of situation. There were not a lot of systematic approaches to things at that point, although Jim had developed a few. It was still a "fly by the seat of your pants" kind of operation; and the more formal approaches to things that have worked so well for us really evolved over a period of time.*
>
> *I'm just embarrassed to say we had no method of projecting sales. We just went out and sold all we could and hoped we beat last year's performance. Then Jim attended a seminar one summer at Harvard, and came back with this plan on how you project sales and try to exercise a lot more control over what you are going to do. It was this kind of thing, the little seminars and special kinds of training sessions and reading a lot of books, I think, that got us into a more business-like approach.*

During their first year together, Jim and Roger refined the company's marketing strategy and developed systems for managing and motivating the growing salesforce.

Heavner's marketing maxim became, *"In unmeasured radio markets, great selling can rescue poor programming, absolutely; but great programming can never rescue poor selling."* Therefore, Jim placed most of his emphasis on the sales side. Given the nature of the market, he concentrated on what he referred to as the "humpability factor" in his salesforce. *"We were successful in dealing with retailers because we would just outwork the other guy."*

George McCall, a college friend of Roger's, joined the sales staff in 1968. At that time, Roger became sales manager and Jim assumed the duties of general manager. George quickly came to understand the meaning of the *"humpability factor."*

> *We had to leave at nine and be back at five, and you did <u>not</u> show your face back here 'til five o'clock ... I was scared. <u>I</u> mean I realized that this was something I had to do to succeed.*

With Roger, Jim developed an intensive sales training and development program that was applied to all newcomers in sales and which was still in place in 1978. There were three basic components in Heavner's salesforce training and development program: (1) bottoms-up goal setting, (2) high teacher-pupil ratio, and (3) collaboration based on a team bonus plan.

Although Jim had become convinced that "if you are looking after the

best interests of the individual who's working for you, he or she will tend to look after yours," the Harvard program provided him with the process to link individual and company goals.

> *What I had not thought of before, was that you could lock that individual goal into a highly detailed planning process in which you analyzed monthly what you were doing on an account-by-account basis, from A to Z, plan a strategy for every one of those accounts, and assign responsibility for it. Then you had a much higher chance for success and it increased the purposefulness of the people doing the selling. And it really did work. . . It's the sweet spot. If I'm right, it's the most important thing we do. If I'm wrong, it's the most expensive.*

As Roger recalled, the monthly goal setting and review process was, *"Very detailed. It was not enough for a person to come in and say, 'I'm going to do $100,000 in sales next year.' That person had to show how he or she was going to do it."*

Jim placed the monthly goal setting process in a team framework. His emphasis was on developing new sales people, and the record of the approach reveals that he has never had a failure at WCHL. Collaboration rather than competition was Heavner's overall approach. He emphasized that,

> *I think I can increase their "humpability rate" fairly significantly with a highly competitive situation. I could give away individual prizes and incentives and I think that would hype up productivity for the short term. In time though, there will have to be winners and losers ... and you would have high turnover ... My observation has been that in companies where you have high turnover in the sales area you also have very unpredictable sales curves.*

He set up a reward system for the salesforce with the joint objectives of maximizing both the success rates of new sales people and the development of general management talent. As he explains:

> *If you create a situation in which you have five motivated teachers working on one student, it seems to me that you cinch the learning situation ... So what I do is tie the compensation of the veteran members of the sales team to the performance of the new person. That way, the newcomer gets a lot of training. Also, each salesperson personally must approve the hiring of each new member. The payoff is twofold. First, you increase the probability that the new person will learn and succeed. Second, you are conditioning future managers to get comfortable with the idea that they are going to be dependent on the performance of others for their success.*

New sales people had to earn their way into the sales team. For example, they might start at a $10,000 annual base salary.

> *We give them a grub stake of $3-4000 a month in the business which, if it's done right, is picked to be a little bit of every-*

thing. People who love us and will just die for us, and some people who need to be sold a little bit. We want them to get some successes. They're paid half-commission on that business. They're then given a full commission on all the new business they bring in.

When the newcomer's commission reaches a level at which total compensation exceeds base pay, he or she is paid an override each month. When the newcomer's total compensation reaches or exceeds $1,000 a month for three consecutive months, he or she is converted to a minimum guarantee of $12,000 per year, given a car, and accorded full membership in the team process. At that time the initiate and all members in the team are paid the same way on a team bonus at the end of the year.

... if it goes as we design, when he or she is knocking on the $20,000 door, we want to have created an opportunity for that person to be a sales manager.

The reports of two sales trainees who became senior vice presidents of The Village Companies attest to the effectiveness of Heavner's motivational concepts.

Kay Allison:

I literally fainted on the day I was supposed to go out to begin selling. I was scared to death; you know, the whole nine yards. But I had received good coaching from Roger Jennings and I went out and was successful, or at least he made me believe that.

George McCall:

I had just been fired from another job, and that will flat get your attention! But with Roger, I was a miracle worker! Four months from when I started I was commissionable [George's commissions had exceeded his starting base salary for three consecutive months].

Not long after these salesforce concepts had been implemented, the FCC granted Heavner's petition for night-time broadcasting. Gone were the frustrations of heliotropism. By 1969, Heavner's growing sales team was primed under the leadership of Roger Jennings to make the most of the night-time air space.

With the growth and development of the salesforce and the expansion in air time, the company began to pile up the resources which led to its expansion into other businesses. As Jim recalls,

We had to expand. We had established an internal intrinsic need to grow. Moreover, the tax structure requires you to grow or die. You don't have any choice but to grow ... Suddenly in 1969, we were paying 50¢ to Uncle Sam on every dollar that came

> *in the door. That's the year we started our profit sharing plan and all kinds of things to shelter money. It was in that environment that we started The Village Advocate.*

At about this time, Jim approached Sandy about the issue of ownership. Although Jim was satisfied with his increasing share of WCHL, his focus was on future developments in the company. As a result of these discussions, they agreed that Jim could put up half the money for each new venture and that they would share ownership 50-50 in all new businesses.

The Village Advocate

The idea for a "penny saver" newspaper came from Roger who, in turn, had been persuaded by a client who told him, *"They just make more money than God!"* The paper would contain advertisements and feature local color stories. It would be delivered free to every Chapel Hill resident. Revenues would be generated from the sale of advertising space alone. As Sandy McCalmroch explains,

> *Jim had great ambition to expand, but we found that, at the time, it was hard to get the money to start in the radio field. We found that we could start The Village Advocate on a lot less money.*

Jim added that a court decision, involving a Boston newspaper, also tempered his decision to avoid new radio station acquisitions during this time. According to Jim, this decision by the FCC to revoke the license of the newspaper's television subsidiary, in response to a campaign mounted by a public interest group, created a lot of uncertainty among members of the radio industry about the risks inherent in a broadcasting license.

In addition to these concerns, the Chapel Hill market looked right for a "shopper." The village had a thrice-weekly newspaper that reached less than 50% of the local households. Jim and Sandy thought that their professional sales approach would enable them to compete effectively with the local paper.

But the decision to initiate this new venture, particularly this kind of business, was not an easy one. Would a "throw-away" paper damage the image of WCHL in the community? Jim reflected on this difficult choice:

> *The thing we felt we really risked in that thing was our reputation. It was one of the few times in my adult life when, professionally, I've experienced anything I could really call terror ... in deciding to crank up that thing in our home town and stake our reputations on the line with the idea that it might not make it, and go absolutely nose to nose against a 50 year old local newspaper ... Except for local introductions, we never allowed a WCHL salesperson to make a single sales call for The Village Advocate.*

Jim discovered that the National Association of Advertising Publishers served as a clearing house on "shoppers." So, for a $150 membership, WCHL

was inundated with information. Jim attended the NAAP national conference where, by asking everyone he met who the smartest shopping guide publisher was, he identified a husband and wife team in Des Moines. He spent a week following the duo around Des Moines.

> *I came back feeling that I knew everything there was to know ... I spent 18 hours a day with them ... they physically would lay out each page ... and I went with them to the printer and everything, including sales calls.*

Jim encountered considerable difficulty in trying to attract someone to manage The Advocate. After repeated attempts to hire someone, he brought in a public relations staffer from the state capitol and assembled a small, separate sales staff for The Advocate. Looking back on this event, Jim observed that the new manager's,

> *... success as a publisher of The Advocate was almost totally a product of our system. He was 31 years old and making somewhere around $10,000 a year. He had not accomplished anything really spectacular in his professional life, and we still took him. In the five years before he left the company, The Advocate went from zero to $500,000 in total billings. He left the company with some cash from the sale of his stock to start a venture on his own which subsequently failed.*

The Second Advocate - Debacle

The Village Advocate did so well the first year, and cost so little to create, that Jim and Sandy began thinking of branching out into other cities and eventually franchising the whole operation. Their pilot test of these ideas, which began only a year after the Chapel Hill shopper, was to start a second Advocate in another college town in North Carolina. The deal, a 50-50 joint venture between the company and a local partner, created a situation in which Jim and the other partner had equal management authority. The test was Heavner's first important failure, and he learned two lessons from it: do your homework and avoid dual-management situations.

First, Jim failed to attach enough importance to the strength of the local newspaper. As soon as the local paper management got wind of Jim's plans, they created their own shopper that Jim believed was produced below actual cost and that was, in his view, "against the law."

> *I was supposed to bring the sales expertise to it and he was supposed to bring the local management to it. But we found that having two chief executive officers is worse than having none ... you can't get a decision. It took us a year to decide to sue for relief ... I am convinced that if either of us had been in charge, the venture would have been a success. In fact, my partner and I remain close friends and he has become a very successful broadcasting executive in the region.*

... we told the guys at the paper, that if they would start charging a competitive price and if they would pay us $25,000, we'd drop the suit. They paid us $25,000, but by that time the battle was already won. They had nudged us out. So we got out of it.

During this episode, Roger Jennings had been promoted from the position of WCHL sales manager to general manager of The Village Advocate. Under Roger, sales at The Advocate continued their upward climb. As Roger remembers,

There was a philosophy in the early stages that we were all working together toward a common purpose; that the goals of the individuals were compatible with the corporate goals. You didn't worry too much about the appearance of things.

In 1973, I left CHL to run The Village Advocate. It wasn't very prestigious. I was the sales manager at CHL, and everyone who knew anything about us assumed that someday Jim would step down, or step up, and I would be the manager of WCHL ... that was sort of the natural order of things. But Jim and I got together and decided that the best career path for me would be to try to strike out in an expansive move ... So I waived my opportunity to manage WCHL and went over and ran The Village Advocate to learn that business.

Well, that raised a lot of eyebrows. People wondered what had happened to me ... had I gotten sidetracked, or demoted, or just what. And, in all honesty, that didn't bother me at all.

The Print Shops

The discovery of the Print Shop was another of Heavner's "marvelous accidents." He had taken a walk down Brattle Street in Harvard Square one afternoon while attending a seminar on sales management at the Harvard Business School in 1970. As soon as he walked in the store he recognized its potential in Chapel Hill. As Jim recalls,

Two or three things caught my attention. One was instant dry mounting of prints ... I'm looking at an easel that says "Dry mounting on styrofoam while you wait." I thought ... "Um ... very interesting. Instant gratification." Them I began to think, "McDonald's ... um ... interesting idea." The price was acceptable. The other thing that intrigued me was the way the merchandise was displayed. I had an idea that a lot of people would buy a lot of art, but they are intimidated by the idea of having to go in and display their lack of knowledge.

I wandered into the back room, and 30 minutes and two beers later the manager was showing me his books and telling me how to do one in North Carolina.

In 1973, when Chapel Hill's first and only shopping mall opened, the Print Shop was one of the most successful stores in it. Jim put in "a little training

program" for the employees which emphasized both merchandizing and strategy. The demand for low cost art was high among university students and was stimulated by the rapid increase in new households in Chapel Hill.

As Jim explained, *"We're not in the art business; we're in the business of making people happy with what they hang on the wall."* But, the demand for more expensive frames was so great that Jim soon replaced the framing contractor with his own framing operation. Sandy also remarked that the Print Shop had a side benefit of putting WCHL in the shoes of a retailer. To him, it was very helpful *"... to open a retail business and have to sit back and wait for customers to come to you rather than you go to them. Selling like you do in broadcast advertising is just an entirely different ballgame."*

The Programming Side

The programming side to Village Broadcasting consisted of the program director and the announcers, disc jockeys, copy writers, and support staff involved in planning, designing and operating the broadcasting activities of the station. Beginning with the founding of WCHL, the predominant strategy had been to be the training center for programming talent throughout the region. As Sandy explained,

> *We knew that we were just a training station for the Carolinas. [We existed initially] because of our ability to use college talent at a very reasonable price. We could afford only to use that talent. We couldn't afford to keep them after they graduated; we didn't have any place for them to go.*

Blessed with the strong Radio, Television and Motion Pictures Department at the University, located only a mile and a half away, WCHL management always found an abundant and inexpensive supply of talented and eager part-timers to meet the station's programming requirements. To obtain the most from these college students, Heavner adopted a policy of "helping them meet their goals, inside or outside the company." Because of the single-cell nature of the initial company, he attempted to compensate for the lack of advancement opportunities within WCHL by creating opportunities for programmers elsewhere in larger radio and television operations in the region.

Often when an employee from the programming side approached graduation, he or she would consult with Jim about career opportunities. Invariably, if the individual's commitment to WCHL had been high, Jim returned the company's commitment to the individual by locating attractive employment elsewhere. During the company's pre-expansion phase, many of the part-time announcers and news reporters moved from WCHL at graduation to become "anchor men" and "morning men" at larger stations in the region. Perhaps the best story, and the one still very much alive in the programming group, is the one told about Jim Lampley, a bright and innovative stringer in sports broadcasting.

Lampley developed an evening sports program that involved debates between coaches in the Atlantic Coast Conference on the eve of major contests.

His style was engaging and he always seemed to ask the really interesting questions. The program became an overnight success. But, as with so many others, when Lampley reached graduation the growth in WCHL had not been sufficient to enable Heavner to offer him an appropriate opportunity within the company. So, as the story goes, Heavner wrote Roone Arledge, Director of ABC Sports, and helped mount a campaign to get Lampley's name before the executives of ABC. Lampley has been a sportscaster in that national network ever since.

Throughout this early period the opportunity balance favored the sales side of the company. It was obvious to all that Jim had decided that future general managers were to be developed within the sales group. The sales force bonus system and career development program, that involved formal management training and intensive in-house coaching, reinforced this imbalance. The social climate of the late 1960s and early 1970s exacerbated it.

From the sales point of view, the social unrest and the questioning of authority in general, and the capitalist ethic in particular, made recruitment more difficult. On the programming side, however, these values and predispositions could not be screened, but were internalized within that part of the organization. WCHL became a microcosim of social unrest: money-oriented, upward-mobile sales people rode in uneasy harness with the artistic and stifled programmers. Kay Allison, who arrived on this scene in 1972, described what she found:

> *From the sales side, this was a place of great opportunity. There was the opportunity to sign on with a group of close-knit, aggressive, young people who had some pretty big ideas for themselves ... that in growing with the company one might achieve riches and fame ... On the production side, you just think of individual conversations, of sniping at sales people because of their position in the company. If anybody stayed a year he or she was a vet!*

This state of affairs persisted through the early 1970s. For instance, until 1974, Heavner kept in his desk what he referred to as a "People and Sales Growth" chart. It summarized key personnel additions and other important business events and linked them to estimates of how much each contributed to sales growth in the company during their first year of placement or occurence. The notes scribbled beside his ever-increasing sales curve are reproduced in Exhibit 2. Reviewing this period, Jim said,

> *In the interest of accuracy, you'd have to say that while the sales thing was developing in a remarkably predictable way, the era of the 60s, my first decade there, was marked by a fairly high degree of job dissatisfaction in the programming area. On balance, we didn't have anybody that came out of there thinking he or she had worked for a very select boss.*

Programming talent and motivation, as measured by the number of annual broadcasting awards captured by WCHL, waxed and waned with the evolution of the company. Awards were frequent when Heavner guided programming and during the period he still had time to be closely involved with program directors.

Exhibit 2

THE JIM HEAVNER STORY (A)

"People and Sales Growth"*

1967	Add Roger Jennings to WCHL (sales dept.)	+ $33,000 in WCHL sales
1968	Add George McCall to WCHL (sales dept.)	+ $15,000 in WCHL sales
1969	WCHL becomes a night-time operation	+ $73,000 in WCHL sales
1970	Village Publications is created	+ $134,000 in Village Publications sales
1971	Add another person to WCHL (sales dept.)	+ $36,000 in WCHL sales
	Add two persons to Village Publications	+ $45,000 in Village Publications sales
1972	Add two more persons to WCHL (sales dept.)	+ $117,000 in WCHL sales
	Add Kay Allison to Village Publications	+ $81,000 in Village Publications sales
1973	Add Geiger to WCHL (sales dept.)	+ $97,000 in WCHL sales
	Transfer Jennings to head Village Publications	+ $102,000 in Village Publications sales
1974 (projected)	Add one person to WCHL (sales dept.)	+ $60,000 in WCHL sales
	Add three persons to Village Publications	+ $124,000 in Village Publications sales

*Personal notes kept by Jim Heavner until mid-1974.

But as expansion occurred, together with Jim's obvious devotion to the development of the "sales side," disenchantment among programmers resulted in less impressive broadcasting results.

Village Communications: The Lexington Venture

The fiasco with the out-of-town Advocate caused Jim and Sandy to consider a strategy shift. They knew they could run successful radio operations and the combined cash flows of WCHL and The Village Advocate now made it possible for them to consider broadcasting acquisitions. As Sandy explained, *"We went back into the radio business because you can get rid of a radio station; everybody understands it."* In fact, it was general knowledge in the industry that a radio station with no frills and with a poor location could be sold for about 2-1/2 times annual revenues. Sandy and Jim believed this multiple would only go up with time because of the limited number of stations available.

This was 1973; a year in which Jim and Sandy had consulted an "estate planner" who, in turn, had informed them that their goals for the future were quite different. For instance, Sandy had a number of financial interests in the village that might benefit from less commitment to a high-leveraged broadcasting operation. Based on the discussions which followed, Sandy suggested that Jim assume a majority share in all future expansions.

That same year, Roger was sent out on a mission to find a suitable radio acquisition. After rejecting several possibilities, the company negotiated a package AM-FM combination in Lexington, Kentucky, that became Village Communications. Even with the enhanced cash flow, however, the company had to stretch with outside financing to acquire the new stations. Sandy took a one-third share and Jim took a two-thirds share. They decided to offer portions of their ownership to the managers they would select to run these ventures if they were successful.

Lexington was another Southern university town, only considerably larger than Chapel Hill. According to Jim, both he and Roger recognized that Lexington was going to be a challenge:

> *Roger perceived, and I think correctly, that going to Lexington was going to be the most difficult, challenging assignment he'd ever make. We did not have experience in a market that size and we didn't have a lot of personnel. We had no conception at that time of how important it would be to take your own people, experienced people, and plug them into a turnaround operation.*

Hindsight confirmed Roger's premonitions and revealed a number of other factors that both he and Jim found to be more important than anticipated. For instance, Lexington was a rated market, and the AM station had a very poor market rating. It also had an unfavorable dial location, at the end opposite all the popular radio competitors in Lexington. The FM station had a good sales record, but the AM station would require a major programming overhaul that might cause its traditional clients to turn elsewhere. Then too, Lexington was not the village.

Heavner sent two general managers to Village Communications, each to run his own station. Both were to occupy the same building and to share certain resources, including a common administrative staff. Roger Jennings took the AM station which posed the greatest challenge. An individual who had successfully engineered a turnaround in one of the South's largest radio stations, was brought in to run the FM operation that was already doing very well. Jim remembers that the FM manager frequently complained of "the bureaucracy" in his former organization; but only later did he realize that the new manager was going through a complete life change. After taking the summer off, the newcomer announced to Jim that he was leaving his wife of over two decades. Within two months, one of Heavner's Chapel Hill employees had left her job and stock option to join the FM manager in his new life in Lexington. Jim continued with obvious emotion,

> *Roger and the [outsider] came into my office one day shortly before they left for Lexington and said that they had had a meeting and that they wanted me not to come to Lexington because they wanted all the troops to know they were the bosses, not me. Hmmm. The concern about the bureaucracy ... being carried right through to the situation in Lexington! ... Within weeks it became obvious that the operation was not successful. We were losing money.*

In terms of revenues, Village Communications was half a success, half a failure. Advertising sales for the FM station took off smartly, but sales for the AM station continued to stagnate well below the more popular AM stations in Lexington. Moreover, monthly expenses were exceeding the joint budget for both operations by roughly 80%.

Personnel-wise, the early operation of Village Communications was <u>a disaster</u>. According to Jim,

> *Village Communications was totally unsuccessful in recruiting a single salesperson out in Lexington who could cut it for us. You know, we had zero failures among people we had recruited after we established our system at WCHL.*

Even the sales and programming people sent from WCHL to Village Communications quickly became disenchanted and left. These individuals had been patiently coached and groomed in the home operation.

Jim fired the FM manager after the first six months of the Lexington venture, and gave Roger responsibility for both operations with a mandate to *"get the damned thing on budget!"* Roger described the situation as follows:

> *We went into Lexington just about as unprepared for that kind of venture as I think a company could be. We brought in a seasoned manager from another radio station, who went up there with me as co-manager, but even he really wasn't prepared. He was a great salesman ... but in many respects was totally incompatible with the way we want to run a company. The kinds of people that he was bringing on board were the kinds of people that I felt were not in the mold of what had been successful for us. They had a*

great deal of loyalty to him personally, but very little loyalty to our objectives as a company.

Overall, I think we underestimated the severity of the problem. We went with too few resources in terms of our own kinds of people. We did not fully appreciate the technical and physical problems that we would encounter. We went too far away from home the first time. We probably went into a situation that, ideally, we shouldn't have until we had two to three other expansions under our belts. We went into a larger market than we were accustomed to; into a very head-on competitive situation.

We took the attitude that if we put in a good radio service and gave people an alternative, and if we were aggressive and promotional, it would do the trick. But the listening habits were so engrained in people, and we started from such a zero point, that it became very frustrating to all of us very soon. We had anticipated going in there and, frankly, just turning the town around real fast.

Roger, who Jim regarded as having *"overidentified"* with his staff, eventually was relieved of his duties as general manager of Village Communications. He was replaced by Peter Jorgenson, formerly sales manager at The Village Advocate. Looking back in 1978, Roger commented on the damage to his relationship with Jim the Lexington experience had caused:

It destroyed the relationship ... a toll was taken on both parties as a result of this experience. When you are the person charged with the performance of a new entity and it is not coming anywhere near producing at that level, especially when you are accustomed to calling your shots pretty well, it is a deflating experience.

Both of us over-reacted. I probably, in retrospect, had let the problems get in the way of solutions; and really felt the whole thing was just a tremendous mess. I also could see the other end; and there was no question in my mind that the home office was over-reacting, because my point of view was that nobody had to tell me, or remind me, how bad things were. Nobody had to tell me what our obligations were. Nobody had to motivate me to try to do things to correct it. The problem was, and I still hold this view, that the old solutions just weren't adequate; that the people here -- Jim is the embodiment of that -- were calling for the old standard solutions that had worked in Chapel Hill.

We're a great rah-rah, cheerleading kind of outfit, and I subscribe to that; but we had a situation there where we didn't have people who had come up through our ranks. We had outside, cynical, "show me," types. You know, "Don't tell me how great it's going to be. Show me, then I'll believe it."

I felt that we were up there trying to crawl, and the kinds of sessions we would have when Jim would come to town were talking

about how we were all going to run the marathon. All we were trying to do at that point was just crawl! And I felt there was a real mismatch in what was being said to the people and what they could hear at that point.

Enter Woodruff and Financial Controls

The first year of operation with Village Communications made it clear that better company-wide financial controls were needed. From Kay Allison's perspective,

It was a major financial investment for us. The fact that it did not turn around immediately has made us more conscious of cost accounting and bottom lines and all those good things.

While Jim was proud of the company's successes in developing "people skills" among his potential general managers, he realized along with other company leaders that financial expertise was the company's weak spot. Thinking specifically about the Lexington situation, he said,

Anybody that loses money as fast as we did needs somebody to count it! ... George McCall [who became general manager of WCHL at the start-up of Village Communications] *threatened either suicide or early retirement because we were having all kinds of problems. We were just outgrowing our system.*

It was under these conditions, within a few months of the start-up of Village Communications, that Bob Woodruff was hired. Jim approached Arthur Anderson, the firm that had helped arrange the financing for the Lexington venture, to see if they could recommend someone to help him manage the company's increasingly complex internal accounting and control functions. Bob, a CPA with ten years of experience at Arthur Andersen, was recommended.

Bob's primary role focused on managing the growing financial affairs of the company. He set up and refined budgeting on a divisional basis and was a key figure in the allocation and monthly review processes. In addition, he soon became the chief negotiator of company acquisitions and divestitures and the primary link between the company and financial institutions.

By this time, the company had four business divisions: Village Broadcasting (WCHL), Village Publishing, The Print Shop, and Village Communications. Bob and Jim decided that each division general manager would be accountable for division performance in terms of sales, budget and operating profit. As Jim described, annual goals were formulated by division managers using a bottoms-up approach based on the personal-development and performance goals of each subordinate. Each division manager would, then meet with Jim and Bob to "negotiate." During this meeting, the figures would be "massaged." In addition, self-development and subordinate-development goals were reviewed; they were especially important for the general managers of WCHL and The Village Advocates. As Jim explains,

I am willing to acknowledge that the company is always going to want more revenue than the troops are going to want to deliver. That's just the nature of the beast. I talk about expectations and they talk about goals.

Bob and I have looked at everything and we've massaged the marketplace. Based on the assumptions that retail sales will increase by this amount, fueled by this much inflation; based on the expectations that our sales team will stay intact for the coming year, it is my feeling that it is reasonable for WCHL to expect this group of people that we've put together to have an X percent increase for the year, which might be 18%. Then, they go back and work with their people. They know if they come back to me with a plan that will get us more than an 18% increase that I tend to be very generous in rewarding the achievement of that kind of goal.

Sandy spoke very highly of Bob and the systems he had helped Jim refine:

Bob sure has been a life saver. My knowledge in financing was very limited ... I had nowhere near the ability that Woodruff has ... He certainly has taken a load off of Jim ... in being the intermediary between Jim and the managers of the various divisions.

From Jim's point of view:

He's just great! He's a confident, right-hand man, manages a hard set of books, is an excellent negotiator, and has a comprehensive knowledge of tax law. He's conscientious to a fault ... Marvelous guy.

<u>Turnaround in Programming</u>

The lessons learned from Lexington also made it clear that well trained and coached company people were essential if new acquisitions were to become successful. The individuals affected the most by this turnover in realization were the programmers. No longer was the policy of "tolerated turnover in programming" viable. Now it was important to build into the programming side the reward systems and developmental activities which had proved so successful for sales.

Jim now felt that it was a "cop-out" to ignore goal-setting in the programming area simply because tasks there were more difficult to quantify and link to company performance. *"We pretty much did with Bob Holliday* [current program director at Village Broadcasting and the only program director in the company to hold the rank of vice president] *what I did with Roger Jennings."*

From Holliday's perspective,

Life in programming and production has definitely changed dramatically since [I came aboard in] 1973. I think, necessarily, five years ago the company had a heavy bias toward sales people. The emphasis was on having a first-rate sales department and, regrettably, once in a while the programming people got run over.

But I think those who survived can attest that it's much better today and those who've come back are always amazed at how different things are today.

Holliday indicated that the company was now keeping score in programming. Such things as the quality of air sound and being on budget were assessed regularly. For example, every Monday evening, Holliday has a staff meeting in which announcers bring their "skimmers" [a tape which telescopes a performer's air shift]. Members of the group criticize each other's shows. Holliday also explained that he was hiring better people:

We're more competitive in what we pay and we're more expansive in where we look for people. So, the announcers we hire now are better; they're more talented. They have more room for growth. As a result, they're going to feel better about where they work ... The salaries our top programmers are making now are virtually double what they were making five years ago. Programmers, in some cases, are making more than sales people.

When asked what his primary role was, Holliday replied,

My biggest role is as a people grower; and our biggest need, other than doing the best we can with the people we have, is to find new people and develop them.

New Businesses Division

Jim set up a New Businesses Division for Roger to run after he returned from Lexington. Roger was given some stock in these businesses and George McCall was moved from general manager of WCHL to work with him. Lee Hauser, who had trained in WCHL sales and was WCHL sales manager, was promoted to general manager of Village Broadcasting to replace McCall.

Over time, the excess printing capacity of The Village Advocate had spawned a number of small ventures. By 1976, the New Businesses Division contained: (1) Village Graphics, the artwork operation supporting the company's printing operations; (2) the Sports Network franchise; (3) University Directories, which published student directories for colleges and universities; and (4) Triangle Pointer, a regional tourist magazine.

The Sports Network served to expand audience identification with WCHL beyond the village community to the whole Southeastern region of the United States. Moreover, sports broadcasting was something Jim Heavner liked to do personally. The other three divisions complemented the publishing activities of The Village Advocate.

By the end of 1978, Jim was planning to open another Print Shop in Durham. His second shop was a pilot to determine the feasibility of franchising the Print Shop concept on a regional and eventually a national basis. He felt that the low start-up cost and minimal management requirements of a Print Shop were keys to the franchising idea.

The Village Companies - 1978

By 1978, the evolution of The Village Companies could be summarized as shown in Exhibit 1. Exhibit 3 reveals the pattern of sales growth for the company as a whole, and by major divisions, during this period. But more changes were just around the corner.

By late 1978, Jim had acquired the rights to two new stations in Wilmington, a resort city on the coast of North Carolina. The package involved AM and FM stations. In addition, he had acquired the right to purchase an FM station from Duke University, located less than 10 miles from WCHL. The station had lost money in recent years, and Duke wanted to sell it. But student listeners had appealed to the FCC for a denial of the transfer of license. This action was causing a delay in settlement. Nevertheless, Heavner was confident that he would be able to make the purchase in the coming weeks. This would give him both AM and FM capabilities in his home theatre of operations. Both Wilmington stations were scheduled to begin operations on January 1, 1979. The Duke station could begin operation soon thereafter.

Also in 1978, Jim had opened the second Print Shop in nearby Durham. Finally, construction had begun on both a new half-million dollar printing facility, to be called Village Printing, and a new $750,000 home office building, both located in the greater Chapel Hill area.

It was now the first week in December of 1978. These additions would certainly cause changes in both the present organization chart (Exhibit 4) and financial statements (Exhibits 5 and 6) of The Village Companies.

Current Issues and Priorities

On the eve of the expansion into all these new ventures, key members representing different business divisions and functions within The Village Companies commented on what they believed were the major issues confronting their organization and the priorities Jim Heavner should be focusing on.

From McClamroch's perspective, Heavner's priorities should be to improve the financial condition of the company and to "find the people to move into the expanding system." The two were closely tied. For example, on the financial issue, Sandy commented that,

> *... financing is the prime thing -- how we are going to continue to get the necessary monies needed to grow at the rate I think we have to to satisfy the personnel.*

The other issue posed two requirements in Sandy's view. First, he believed that the base salaries of personnel were below average. Base salary increases, in the absence of promotions, amounted generally to cost-of-living adjustments. Real increases in earnings were obtained through promotions and through the annual bonus plan. For example, for sales personnel and general managers in divisions which met their annual goals, bonuses averaged 30% of base pay. Very little if any bonus was paid to personnel in divisions

Exhibit 3

THE JIM HEAVNER STORY (A)

Annual Sales for The Village Companies:
1966-1977

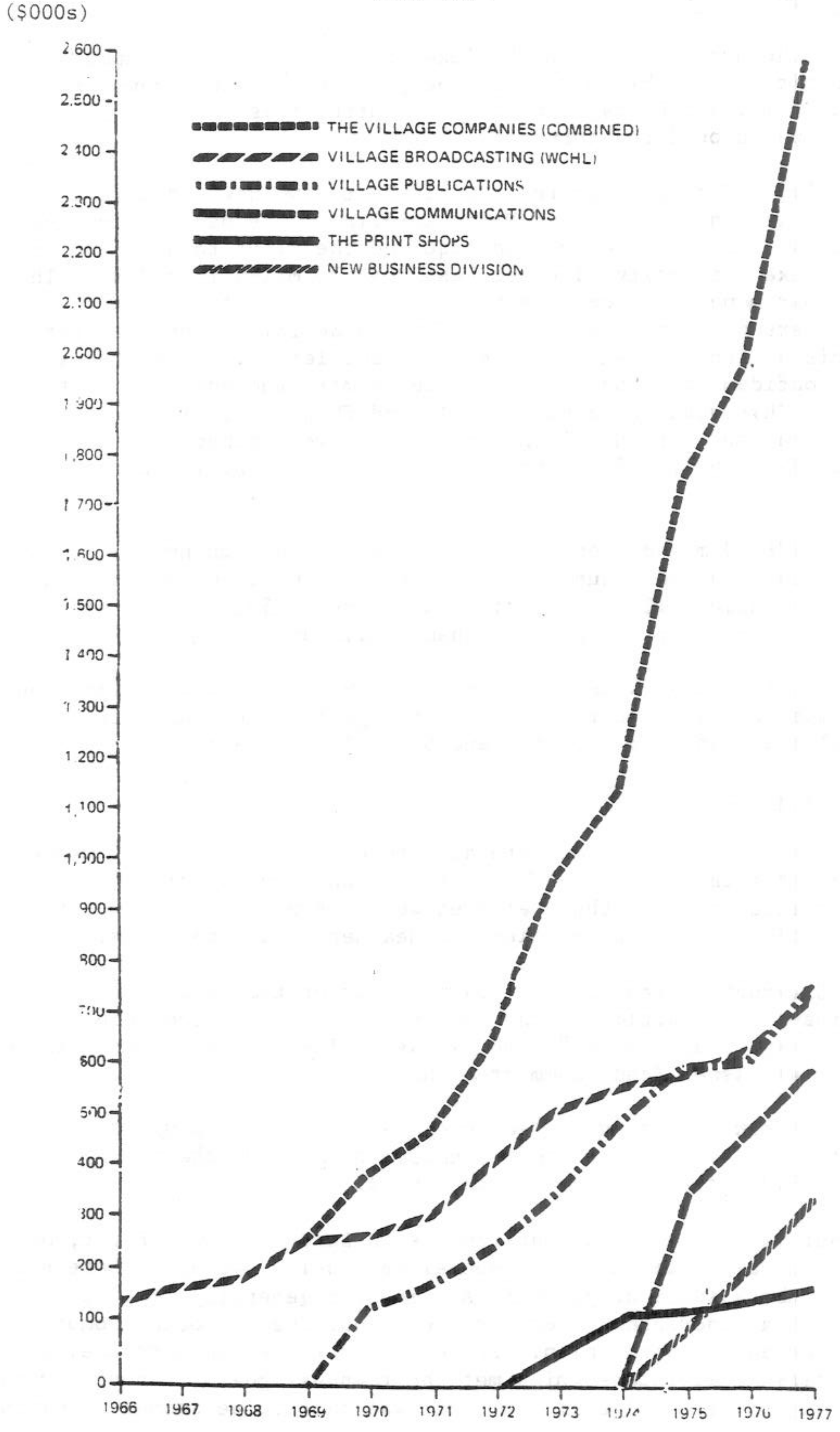


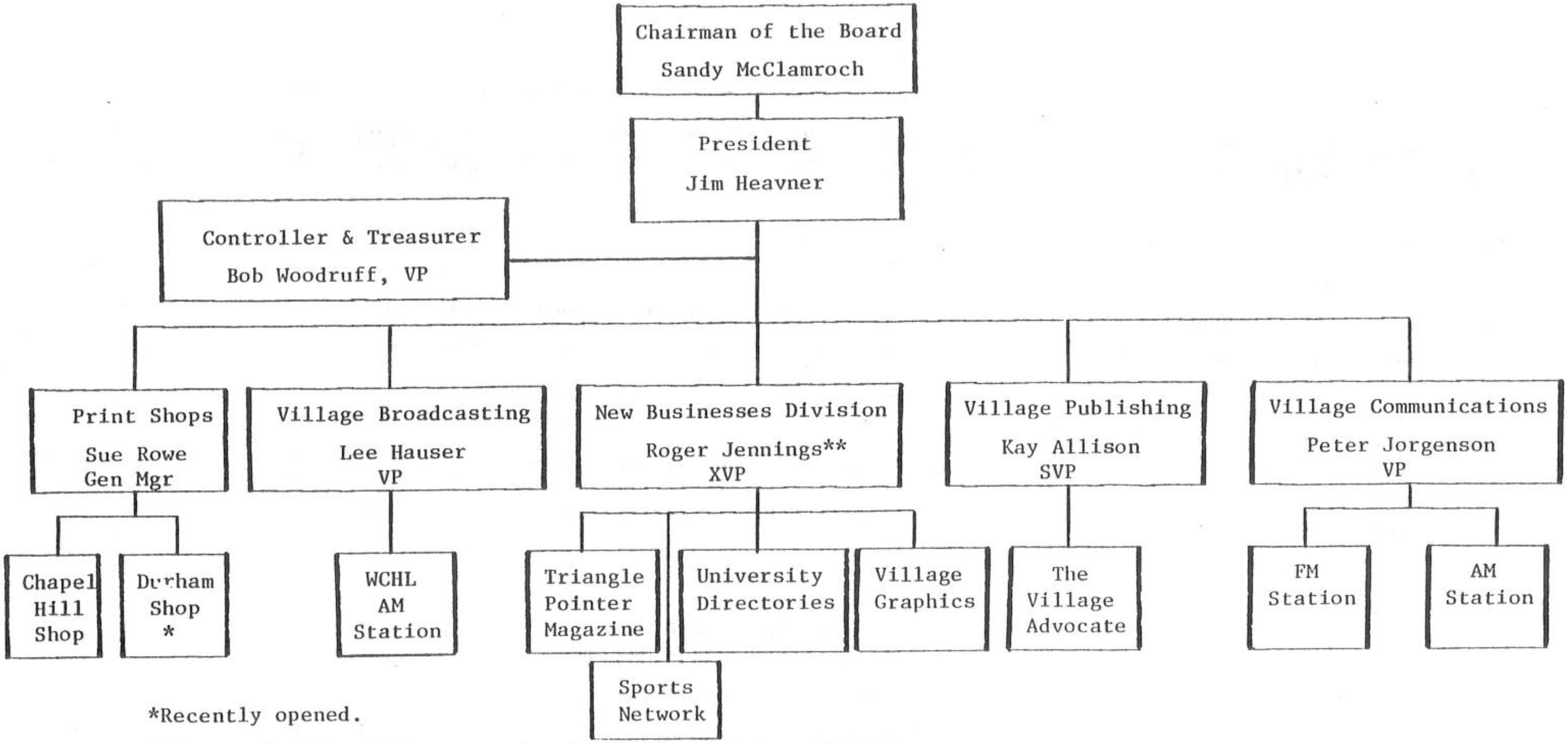
Exhibit 4

THE JIM HEAVNER STORY (A)

The Village Companies, Inc.

Organization Chart

December, 1978



*Recently opened.

**George McCall, SVP, was assigned to this division after Roger Jennings' return.

Exhibit 5

THE JIM HEAVNER STORY (A)

The Village Companies:

Combined Statement of Operations (1975, 1976, 1977)

	WCHL			VILLAGE COMMUNICATIONS			VILLAGE ADVOCATE			OTHER DIVISIONS			COMBINED		
	1975	1976	1977	1975	1976	1977	1975	1976	1977	1975	1976	1977	1975	1976	1977
SALES	$ 591,821	$ 621,320	$ 735,764	$ 347,500	$ 473,500	$ 600,924	$ 603,738	$ 614,998	$ 766,492	$ 91,122	$ 201,941	$ 335,665	$1,634,270	$1,911,759	$2,438,845
TOTAL COSTS AND EXPENSES	324,743	318,722	389,575	455,564	393,558	463,879	481,670	505,593	616,594	59,145	151,377	243,608	1,323,122	1,169,250	1,711,656
OPERATING PROFIT (LOSS)	233,807	276,206	318,884	(147,067)	10,512	71,536	109,016	93,040	140,213	31,977	50,564	83,707	227,733	430,322	614,340
HOME OFFICE	94,620	92,380	102,549	20,100	20,100	24,000	52,200	60,000	66,000	-	-	39,487	166,920	172,480	232,036
PROFIT (LOSS) AFTER HOME OFFICE	139,187	183,826	216,335	(167,167)	(9,588)	47,536	56,816	33,040	74,213	31,977	50,564	44,220	60,813	257,842	382,304
OFFICER BONUSES	100,000	170,000	200,000	-	-	-	76,000	66,000	90,000	-	-	-	176,000	236,000	290,000
PROFIT (LOSS) AFTER OFFICER BONUSES	39,187	13,826	16,335	(167,167)	(9,588)	47,536	(19,184)	(32,960)	(15,787)	31,977	50,564	44,220	(115,187)	21,842	92,304
OTHER INCOME (EXPENSES)															
Depreciation and amortization	(10,572)	(10,127)	(16,907)	(173,153)	(151,732)	(87,627)	(6,224)	(3,462)	(3,121)	-	-	-	(189,949)	(165,321)	(107,655)
Other	(6,869)	6,575	(8,330)	(96,331)	(96,429)	(133,697)	13,443	7,728	(5,137)	-	-	5,688	(89,757)	(82,126)	(141,476)
Income Taxes	(6,500)	(8,900)	(600)	-	-	-	(7,000)	(550)	(3,000)	-	-	-	(13,500)	(9,450)	(3,600)
TOTAL	(23,941)	(12,452)	(25,837)	(269,484)	(248,161)	(221,324)	219	3,716)	(11,258)	-	-	5,688	(293,206)	(256,987)	(252,731)
NET INCOME (LOSS)	15,246	1,374	(9,502)	(436,651)	257,749	(173,788)	(18,965)	(29,244)	(27,045)	31,977	50,564	49,908	(408,393)	(235,055)	(160,427)

Exhibit 6

The Village Companies

BALANCE SHEET*

	1975	1976	1977
ASSETS			
Current Assets	$342,674	$376,442	$710,595
Receivables from Affiliates	9,445	-	20,000
Receivables from Stockholders	-	-	-
Property and Equipment	244,406	230,503	300,626
Other Assets	175,253	105,994	84,301
TOTAL ASSETS	$771,778	$712,939	$1,115,522
LIABILITIES AND STOCKHOLDERS' INVESTMENT			
Current Liabilities	$379,328	$371,281	$781,014
Deferred Revenue	13,144	20,658	67,624
Long Term Notes	485,590	511,339	424,858
Payables to Stockholders and Affiliates	216,000	456,000	435,000
Stockholders' Investment			
Common Stock	124,000	124,000	130,448
Capital Paid in Excess of Par Value	-	-	153,340
Retained Earnings (deficit)	(446,284)	(641,339)	(801,762)
Less: Treasury Stock	-	75,000	75,000
Total Stockholders' Investment	322,284	(592,339)	(592,974)
TOTAL LIABILITIES AND STOCKHOLDERS' INVESTMENT	$771,778	$712,939	$1,115,522

* Contains only Village Broadcasting, Village Communications and Village Publications.

failing to meet their annual goals.

Second, Sandy recognized that the personnel requirements, especially those for middle managers, of this rapidly growing company could not be met by individuals developed in the home division alone. People would have to be brought in and they would have little appreciation of the central values of the core group that Sandy believed were critical in the company's great successes. He saw a major problem in assimilating these outsiders.

George McCall, a member of the core group and now senior vice president, observed that, *"there are an awful lot of strangers in the company now. I mean, we've grown so much that I don't know the names of some of these people!"* He believed the major question confronting Jim Heavner should be *"how do you hold onto good people?"*

> *Because the company has been small, I believe we had a lot of strong personal friendships and love and respect for each other. And I think during those periods some people may have been oversold or bought a little bit more than they should have ...*
>
> *... the idea emerged [in this company] that anytime you're expanding, you have to pay all your profits back in. Sandy and Jim do that ... In a sense Jim's saying, "I'm not the guy taking $250,000 out of this company. We're putting it all right back in." And I feel a bit lower paid than I probably should, but I think that's the reason for it.*
>
> *... See, everything now is down the road; and somebody said, you know, "down the road we'll all be dead." I can wait 'til I'm 65 and the stock I have is projected to be worth maybe $300,000 or $400,000 ... and, you know, at age 65, if I live that long, that will be a nice nest egg. But I don't think at 65 that's going to be anything that I can travel around the world with and not have anything to worry about. So the question is whether one should try to figure out a way to do something on one's own. We were all told we were going to get rich, but I think that truth is nobody gets rich working for someone else.*

Bob Holliday, now vice president and program director at WCHL and the only long-time member from the programming side, identified the following problem which he thought should be Jim's number one priority: *"... continuing to create a climate of growth for the people we now have."* In terms of the opportunities at The Village Companies, Holliday commented that,

> *Like so many of the people in the organization, the difference between how I got started and where I am now is night and day. Rarely have I seen so many individual situations that started so small become so big.*
>
> *... I would have to say that for the short term none of the top managers have any problems ... not getting into Roger's situation ... I do think that the challenge the corporate leaders must*

[deal with] five years from now is how to continue to meet the needs and expectations of people like Lee Hauser, George McCall, Peter Jorgenson, Kay Allison, ultimately me.

It might happen that we generate enough wealth to move into a bigger market and certainly that would be stimulating to people like Lee and Kay; but on the other hand we may have others who get into Roger's situation and say, "Well, it's been a great ten years, but where can I go from here?" I think it's probably just a process of the organization maturing.

During this period in December, Kay Allison, who had moved from part-time sales assistant to senior vice president of Village Publishing in less than five years, reflected on how she came aboard and what the most pressing issues were for the company. Her first encounter with The Village Companies began when she responded to an Advocate ad for a part-time disc jockey at WCHL. She had just received her undergraduate degree in radio and television and was looking for a means to stay in Chapel Hill for the summer. She described her interviews for the job as follows:

I was amazed at how I was coming in to apply for a part-time job and was getting the sort of ninth degree about some things [such as] "What are your goals in life?" So anyway, I talked with a number of people over the course of about two weeks trying to get a $1.65 an hour part-time job! And, you know, it was just getting ridiculous. But I was impressed and I think the seriousness with which they approached this process made me think more. But I mean not many people hire you for $1.65 an hour, which was minimum wage at the time, and make you believe that you are being interviewed to be Chairman of the Board !

The job that finally came agreed with Kay:

I found a pretty open atmosphere with a teaching environment and enjoyed very much doing a variety of things and have said to people since that I think it was a perfect opportunity for me because, at $1.65 an hour, I wasn't too expensive to do anything. [Referring to McCall and Jennings] They came in and cheered in the afternoons or cried together or did whatever was appropriate based on the day's activities. And they were also doing a lot of very creative things.

... it was a 20 hour a week job, taking about 55 hours a week, and I was loving every minute of it ... I would punch out because I knew what their budget was for me and I would take the work home and do it anyway because I just wanted to do a good job and it's part of my compulsive nature. During that period a lot of times I would bump into Roger here working

at night and we would end up talking about life and the meaning of work and a lot of things that I really needed to hear.

Kay missed the close personal relationships of those early days at WCHL, but obviously relished her present position as head of Village Publishing. She believed Jim's number one priority should be personnel development

We just don't have enough people to do what we're about to do; not enough experienced people. It's the whole middle manager thing ... We need some people who have fought the wars and whether they've won or lost have learned something and are able to go out and try again ... We just have really green people ...

Jim's reflections on Kay's rise in the organization revealed his interpretation of the personnel development problem:

When Kay arrived at WCHL, the only kind of coaching she needed was in the area of company procedures ... Even when Kay was working in her original job as a part-time go-fer, she had a special solution-oriented perspective that enabled you to send her on any assignment with great confidence ... When she could not come back with the prescribed solution, she could devise one on the scene in such a way as to leave her superiors an easy opportunity for final approval ... As a result, people working around Kay suddenly found many of her ideas in effect.

Kay's development brings up an interesting question. We know that we can teach systems and instill many new values into a personnel development program; but can we instill an "entrepreneurial mind-set" into these people?

Even Bob Woodruff, the company's controller and treasurer, placed personnel ahead of financial position in his priorities. He believed Heavner's first priority should be to develop general managers *"with the ability to stand alone and manage their operations more like entrepreneurs."*

The departing Roger Jennings belived the company had changed too much. He regretted the loss of excitement and the sense of camaraderie he associated with the small, face-to-face character of the company's beginning. Roger thought Jim's number one priority should be,

... to try to reinstate some of the motivating forces for people who came in a few years ago. I think they are still valid and I believe the company runs a risk of alienating some members of the core group ... I think that with the caliber of people that we have, they deserve more ... it would be beneficial to recognize the need for them to have more autonomy and more authority that would be comensurate to the responsibility with which they are charged. They have tremendous responsibilities and yet I'm not

sure they are in a position to make the kind of commitments [their responsibilities require] ... We have set up a lot of red tape for the purpose of simply making things difficult in the hope that if it is not important enough, you won't pursue it. I rebel at that. I like to think I'm a responsible enough person, and an intelligent enough person, and a mature enough person that I'm not going to bring insignificant things to somebody's attention anyhow.

Part of Roger's observations were a reflection of his resentment not of Bob Woodruff personally, but of Jim's decision to place Bob between him and members of the core group. But Roger had one additional piece of advice for Jim:

... although I think they have learned some things from Lexington, I think there is still a failure to understand the nature of that experience. I think they have seen the more visible signs of Lexington. I think they still have an inadequate understanding of what really goes on ... the dynamics of a new operation; all of the things that are swirling under the surface there. And I think we are still taking an approach of well, by golly, if we are just positive about this thing, it can all come out alright.

Finally, an officer of the bank financing The Village Companies' expansion program had his own opinions of the current strengths and weaknesses of the organization. Heavner had turned to this bank for financing when the bank the company had worked with through the years refused to extend enough credit to finance his expansion plans.

On the positive side, the banker had this to say,

The strengths at WCHL are, number one, they have been in the business 25 years; number two, they are a community-oriented organization, probably as much so as any organization I've ever been around. But, for me, the largest asset they have is their people. Sandy McClamroch is just a super human being, and Jim Heavner is one of the most dynamic, sales-oriented people that you would ever run into. But, it goes right down the line. They have people that are so hyped-up over the company. They think they are the best, and they are the best as far as they and a lot of other people are concerned. And it is just the attitude, the people, the way they go about things. And a new bank in town never expects to land a business like this. But they have growing pains. They wanted to do some things that their other bank would not allow them to do.

I think, also, something very important is [that] a lot of companies you run into, especially the smaller companies where there is control by just a few people, are selfish. They don't want to give any of the company away. Jim is willing to do this. He has told all of these people, the key people, "I want you to grow; I want you to make a lot of money because the more money you make the more money I'm going to make." And, the stock plan,

I think, has really gotten a lot of people fired up. You know, they stay fired up. It gives them a chance to own a piece of the company, and they are going to stay with it. There is no telling how much they could be worth one of these days as long as the company is doing well.

On the matter of current weaknesses, the banker had this to say about The Village Companies:

... as far as their weaknesses, any bank could tell you they don't like to see a deficit on a balance sheet. But it is the nature of the animal to have a tremendous cash flow ... As highly leveraged as they are, their cash flow is their life line. They have to watch that very, very carefully.

But the banker was feeling relatively secure. For one thing, he believed that Heavner,

... could sell just WCHL, the station itself, for $3 or $4 million, pay off everything they owed, have probably a couple of million dollars in cash, and still have everything else they have now ... if they really got into a bad situation.

His confidence in the organization was bolstered also by the presence of Bob Woodruff. When asked how he viewed Heavner's decision to hire Woodruff, he replied,

I think it is probably one of the smartest things they ever did. Jim is an idea man, and he's super. He's a go-go guy and he can sell. He comes up with some terrific ideas, but not all of them are good. But, Bob is a stabilizing force. He and Jim have a relationship where Jim bounces things off of Bob. Bob is a level-headed accountant. Now he's a go-go guy too; but when it comes to hard, cold facts, unless it looks like its going to fly, I don't think Bob is going to go along with it.

Heavner at the Dawn of His Most Ambitious Campaign

Jim was wrestling with these problems on the eve of his most ambitious expansion project. A lot was at stake, not to mention the years of personal sacrifice and the future prospects for Heavner himself.

1978 had been another growth year for Village Broadcasting, Village Publishing, the Print Shop, and the New Businesses Division. Lexington had finally broken even, but only because of the strong finish of the FM station. More important, the Lexington experience had been a real meat grinder, consuming and discarding much of the sales and programming talent Jim had so carefully trained and coached over the years in the Chapel Hill operations. Roger's definite departure in one month was, Jim hoped, the last vestige of that turmoil.

In recent years Jim had tried to encourage an "investment ethic" in his key employees. By now, they owned approximately 8% of the company. In some

cases, he had guaranteed loans at the bank for them, much as Sandy had done for him a decade earlier, so that they could buy stock in The Village Companies. He and Sandy now had equal shares in this growing enterprise.

Scribbled on a pad on top of his desk were some notes he made the night before as he reflected on the immediate future of his expanding venture. Ten years from now Jim would be 49. By that time, he figured, if the company's growth trend of 25-30% per year continued, billings for The Village Companies would approach $50-60 million and his personal holdings would increase by a roughly proportional amount. But the notes he had made the night before were the things that captured his attention now. They read as follows:

"OUR IMMEDIATE FUTURE"

- Uncertainty
- Sandy possibly out
- If we win big in '79, it will produce leaders
- If not, think about:
  - a) divestiture
  - b) recruitment
  - c) long haul
- Opportunities
  - a) broadcasting
  - b) printing business
  - c) Print Shop franchise
- Obstacles
  - a) internal
  - b) leadership
- Great sales organization; questionable marketing organization
- I believe I have a "marketing mind;" do enough of the troops have one?
- Form of capitalization: no retained earnings to avoid taxes; poor balance sheets scare bankers.
- 1978 will be very, very strong except for the huge overexpenditure in Lexington's budget the first two quarters.
- Wilmington sales and programming strategy looks strong.
- Durham sales and programming strategy looks weak; no people; litigation; PR.
- Search for leadership.

Jim had to make a lot of important decisions in the next few weeks. Both personnel and organizational changes would be involved. And he wanted to make the kinds of decisions that not only would help him cope with his immediate organizational problems, but would contribute also to the longer term development of his expanding organization.

On the immediate scene, there were decisions regarding the departure of Roger Jennings, the fate of the Lexington venture, the start-up of new broadcasting operations, and the near-term completion of construction on the separate home office and printing facilities. He had to make decisions now regarding both personnel and organization design to accommodate these changes. He also wondered what changes would be required in the role he was to play in all of these developments.

But he was also concerned about the need to concentrate on issues related to the longer term development of his rapidly growing organization. For example, he was trying to determine what actions he should take to ensure that his company attracted, developed and retained people who had the entrepreneurial talent to sustain the growth and proliferation of the businesses of The Village Companies. And he felt that there was an important connection between the decisions he had to make right away and these longer term concerns. Finally, he was trying to project himself into the future to discover what implications it held for his own role in The Village Companies.

* * *

Harvard Business School 373–103

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ID

WHARTON REPROGRAPHICS

Heublein, Inc. (A and B)
condensed

Charles W. Hofer, research assistant, prepared the original Heublein cases under the supervision of Assistant Professor Norman A. Berg to serve as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

With growth in sales and profits since 1959 far outstripping that of the liquor industry's "Big Four," by 1965 Heublein, producer of Smirnoff vodka and other liquor and food items, had become the fifth largest liquor company in the United States (see *Table A* and *Exhibits 1* and 2).

Ralph Hart, Heublein's president since 1960 and a former executive vice president of international marketing for the Colgate-Palmolive Company, commented on the company's assets:

> Although liquor products account for most of our sales at the present time, we consider ourselves in the consumer goods business, not the liquor business. Liquor is a consumer good just like toothpaste and is sold the same way.
>
> To be successful in this business, you need three things: a good product, distribution, and advertising. You must have a good product. If you don't, the consumer will find you out and you will not get any repeat purchases. You also need good distribution so the consumer will be able to get your product easily and conveniently. Finally, you must have a good, convincing story to tell the consumer about why he should buy your product, and you tell it through advertising.

In 1965 Heublein's management had three long-range goals: to make Smirnoff the number one liquor brand in the world; to continue a sales growth of 10% a year through internal growth, acquisitions, or both; and to maintain Heublein's return on equity above 15%.

A major acquisition opportunity was being considered in the fall of 1965 as one means of meeting these goals. The potential acquisition (Hamm Brewing Company) raised a number of short-term as well as strategic issues, however, which Hart wanted to consider carefully. Hamm was almost as large as Heublein in sales, and therefore the impact of the acquisition on Heublein was certain to be significant. The beer and liquor industries were in many respects

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Table A
Five Largest Liquor Companies, 1965

Industry Rank	Company	$ Millions 1964 Liquor Sales	$ Millions 1965 Total Sales	Total Sales Gain 1959–65	Profit Gain 1959–65
1	Distillers Corporation	$718	$1,005	37%	52%
2	Hiram Walker	598	530	28	46
3	National Distillers	430	829	44	24
4	Schenley Industries[a]	390	461	0	33
5	Heublein, Inc.	123	166	89	259

Note: Derived from various company annual reports
a. Figures estimated

similar, but Heublein had had no direct experience in the beer industry. Hart emphasized that the kinds of opportunities being sought were not just profitable financial deals but rather firms whose operations Heublein's management believed it could improve. Heublein's acquisition policies had been explained more fully by Hart in a 1965 presentation before the Los Angeles Society of Security Analysts:

> Frankly, we take a long, hard look at any potential acquisition. We ask ourselves: "Will the new product or company we acquire have a potential at least equal to existing Heublein products, in order not to dilute present equity? Will new products lend themselves to our channels of distribution and marketing techniques? Will these products have sufficient gross margin to allow for our type of distribution, advertising, and merchandising?"

The question of the Hamm acquisition, then, had to be decided in the context of Heublein's position and strategy and the trends in its basic markets.

Company Background

Market. Between 1955 and 1964, U.S. consumption of distilled spirits[1] increased from 199 million wine gallons to 277 million, or 39% (see *Figure A*). By the latter year some 60 million Americans—about 53% of the adult population—drank some sort of alcoholic beverage and spent about $6.5 billion for liquor, about one-third of the amount spent for public elementary and secondary school education. Excise taxes on these sales ($10.50 per proof gallon in 1965) provided the federal government with about $2.5 billion in 1964, more than the revenue from any other single source except for personal and corporate income taxes.

Rising sales of liquor could be attributed to various causes, including population growth, increased personal discretionary income contributing to a slightly higher per capita consumption, changing social mores, the declining proportion of people in "dry" states, and changes in the population makeup by age group. Edward Kelley, Heublein's executive vice president, felt the growth in liquor consumption between 1955 and 1964 was primarily the result of the increase in per capita consumption, which appeared to be related to the growth in personal discretionary income, and of the spread of drinking to more segments of the population and on more occasions.

Predicting the future in relation to income and demographic changes, industry sources looked forward to an even faster growth in consumption from 1965 to 1970 than was the case from 1955 to 1964—4.5% or more a year, as compared with 3.6%. Since the Bureau of the Census forecast that the 25-to-54 age group would increase an average of nearly 17% between 1970 and 1980, many industry observers felt the picture beyond 1970 looked even better than that between 1965 and 1970.

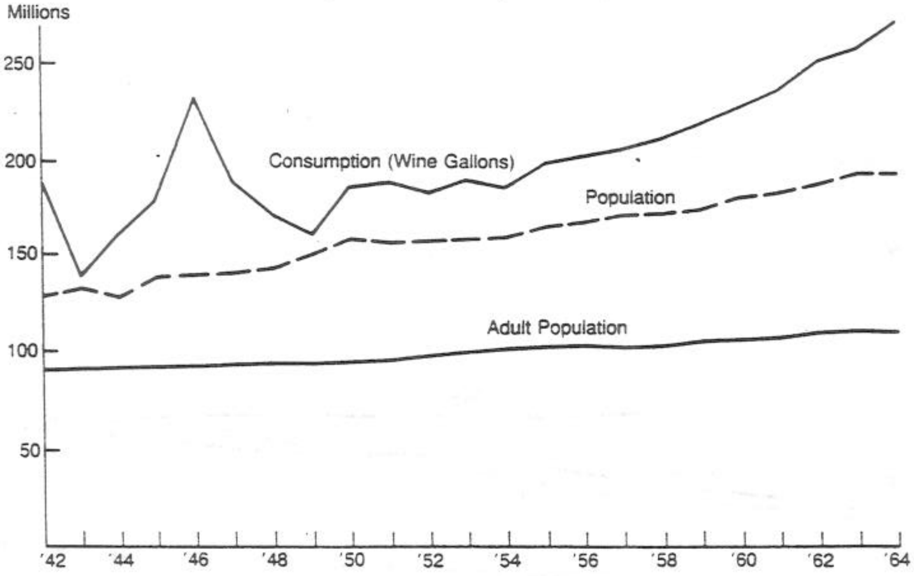
1. Several terms in common use in the industry require definition:

   Proof is a term used to specify the proportion of alcohol in a product. The proof number is equal to twice the percent of alcohol (by volume) in the product.

   A *proof gallon* is any volume that contains the same amount of alcohol as a gallon of 100-proof spirits.

   A *wine gallon* is a gallon by volume (regardless of proof). Thus a gallon (five fifths) of 80-proof vodka would be one wine gallon but only 8/10 proof gallons.

Figure A
Liquor Consumption Compared with Population, 1942–1964



Source: Gavin Jobson Associates, Inc., *The Liquor Handbook, 1965*; cited by Glore Forgan, Wm. R. Staats Inc., in *Heublein, Inc.*, December 1965.

Market changes. Demand for the various categories of liquor was changing as well as growing between 1955 and 1964 (see *Figures B* and C), with a dramatic shift in consumer preference to straight whiskeys, imported whiskeys, and the nonwhiskeys and away from the blended and bonded whiskeys. While some observers felt this represented a return to the pre–World War II relationship that provided straight whiskeys with a slight edge over blended whiskeys, most industry sources felt the shift in consumption reflected a trend toward lightness in liquor taste. According to Roger Bensen:

> The most probable reason [for the trend toward lightness] is that people drink mainly to satisfy social and status needs and for effect, and not inherently for taste. The taste of many liquors is something which new drinkers find difficult to assimilate. Hence, they turn to various cocktails or mixed drinks to disguise the original flavor of the liquor product. And to complete the pattern, people achieve further fulfillment of social and status needs by using the newer, more current, more exotic liquors and cocktail formulations as a vehicle for their drinking.[2]

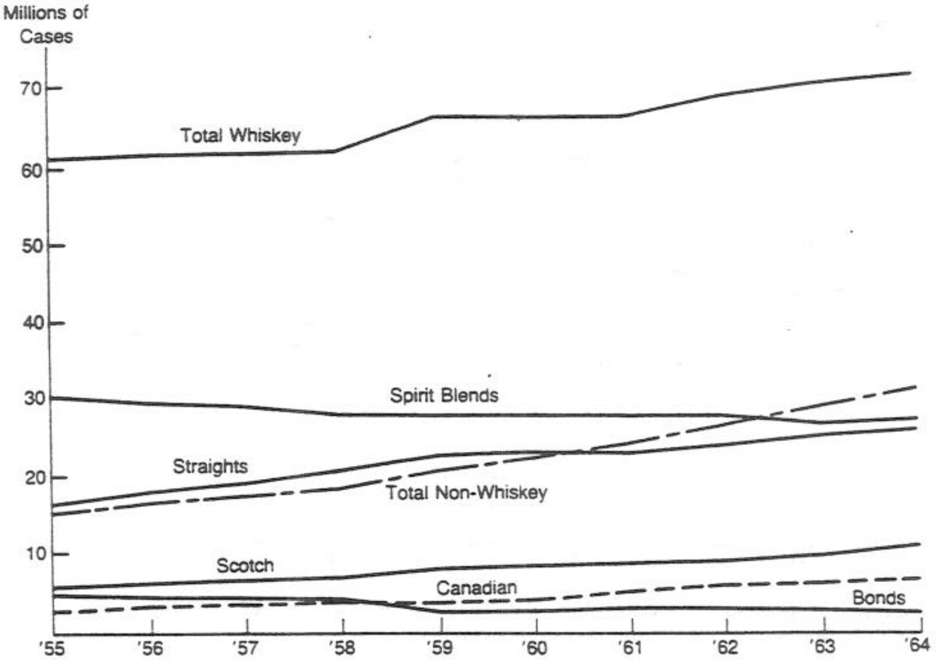
2. Roger D. Bensen, *Heublein, Inc.*, Investment Research Department, Glore Forgan, Wm. R. Staats Inc., December 1965, p. 21.

Some of the most important of these changes are reflected in the figures for distilled spirits entering trade channels shown in *Table B*.

According to many industry observers, one of the more important developments in the liquor industry between 1960 and 1965 was the growth of bottled cocktails. Although they had been on the market for over 50 years, they had shown little growth until 1960. In that year, Heublein, which had almost all of the market at that time, developed a new product formulation, package, and promotional campaign for its line of bottled cocktails. By 1965 volume had increased 100% to an estimated 1.9 million wine gallons, as Distillers Corporation (Seagram), Hiram Walker, Schenley, and others entered the market. Heublein, whose volume increased 60% during the period, still had 55% of the market in 1965. The convenience, low consumer price (only a few pennies more than comparable drinks mixed at home), and the trend toward lightness caused one liquor authority to predict that bottled cocktails might represent close to 10% of the industry's volume by 1975.

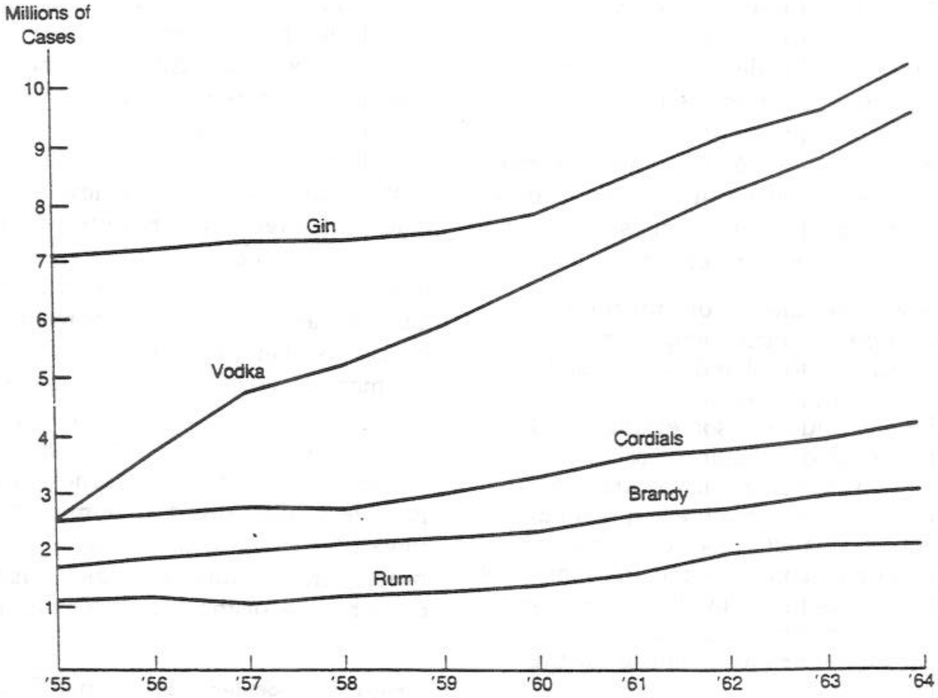
Trends in competition. Between 1955 and 1965 the majority of the companies in the liquor industry followed one of two broad strategies. Most of the medium-sized companies aggressively mar-

Figure B
Whiskey Consumption Trends, 1955–1964



Note: Expressed as a three-year moving average

Figure C
Nonwhiskey Consumption Trends, 1955–1964



Source: Gavin Jobson Associates, Inc., *The Liquor Handbook, 1965*; cited by Glore Forgan, Wm. R. Staats Inc., in *Heublein, Inc.*, December 1965 for *Figures B* and C.
Note: Expressed as a three-year moving average

Table B
Market Changes for Distilled Spirits, 1955–1964

Product Type	Volume (millions of wine gallons) 1955	1964	Market Share 1955	1964	Change in Volume 1955–1964
Whiskeys					
Bonded	12.9	7.9	6.3%	2.8%	(39)%
Straight	46.1	69.6	22.7	24.3	51
Blended	81.5	74.7	40.0	26.1	(8)
Scotch	12.3	28.3	6.0	9.9	130
Canadian	9.2	17.2	4.5	6.0	87
Total all whiskey	161.5	197.9	79.5%	69.1%	22 %
Nonwhiskeys					
Gin[a]	20.7	31.1	10.2%	10.9%	50 %
Vodka[a]	7.0	28.1	3.4	9.8	302
Rum	2.7	5.9	1.3	2.1	119
Brandy	4.6	8.7	2.3	3.0	89
Other	6.6	14.6	3.3	5.1	121
Total nonwhiskeys	41.8	88.4	20.5	30.9	111
Total distilled spirits	203.3	286.3	100.0%	100.0%	41 %

a. Gin and vodka were unique among the distilled spirits since they required no aging. The principal distinction between gin and vodka was that the juniper berry flavor was added to grain neutral spirits to produce the former, while as many flavor-producing ingredients as possible were filtered out from grain neutral spirits to produce the latter.

keted their products in traditional ways. They did not increase, decrease, or change their product line, nor did they attempt to diversify out of the liquor business. None of these companies had a complete line of liquor products, and some had only one or two products. Several of these companies, however, experienced extremely rapid growth during this period. Their success could generally be attributed to having a leading product in one or two of the more rapidly growing segments of the liquor market.

The four major distillers also marketed their products in traditional ways. However, with the exception of Hiram Walker, each of these companies attempted to diversify out of the liquor industry through acquisitions, though liquor accounted for the major portion of the sales of each of these companies in 1965. Moreover, with the possible exception of National Distillers, the major distillers no longer seemed to be interested in further diversification outside of the liquor business in the mid-1960s. Rather, they began to compete more vigorously in all segments of the liquor market during 1964 and 1965, particularly the more rapidly growing segments. The increased competition, coupled with the trend toward lightness, caused John Shaw of Equity Research Associates to predict that "marketing efforts will become more consumer-oriented, stressing appetite appeal in much the same way as the food industry. Overall, advertising and promotional costs can be expected to trend higher, as brand competition remains intense."[3]

Among the companies that had grown rapidly or that competed directly with Heublein were James B. Beam Distilling, Paddington Corporation, Distillers Corporation–Seagram Co. Ltd., and Schenley.

Methods of distribution. Distribution of liquor took two basic forms at the beginning of 1966. In 18 "control states," a state-regulated agency was responsible for the distribution and sale of distilled spirits. Generally the marketer sold the product to the state agency at the national wholesaler price and allowed the state to distribute the products as it saw fit. These states often had laws restricting the type of point-of-promotion advertising that a company could undertake. In the other 32 states, called "open states," distribution was through wholesalers

3. John Shaw, *Trends in the Liquor Industry*, Equity Research Associates, August 30, 1965, p. 6.

who redistributed the product to the retailers, who sold the product to the ultimate consumer. From 1958 to 1964 the number of these independent wholesalers declined almost 43%, leaving only 2,305 wholesalers in 1964 who were licensed by the Federal Alcohol Administration to deal in distilled spirits. This trend, which was similar to that in other consumer-product industries, was primarily caused, according to industry observers, by a serious profit squeeze on the wholesaler, whose costs of operation increased while the retail prices of inexpensive liquors declined because of intense competition—a situation that was aggravated by the spread of private labels. While distillers had not felt the effects of this squeeze by 1964, there was a feeling among some industry observers that distillers might have to lower their prices to wholesalers or lose lower volume lines if the trend continued.

Cost structure. The cost of producing liquor products, excluding federal and state taxes on the raw materials, was relatively low compared to the retail selling price. For example, high-quality vodka reportedly cost about 61 cents a fifth to produce and retailed at $5.75. Federal taxes on raw materials (assuming an 80-proof product) were $1.68 per fifth. In addition, the costs of production, excluding federal and state taxes on raw materials, were often not much different for high-priced and low-priced liquors, even though they were often made through different processes that were said to result in differences in taste and quality between the high-priced and low-priced liquors.

Heublein's History

The House of Heublein was founded in 1859 in Hartford, Connecticut, by Andrew Heublein, a painter and weaver by trade. At that time, the House of Heublein was a combination restaurant, café, and small hotel. By 1875 Andrew's two sons, Gilbert and Lewis, were running the business. They branched out by conducting a wholesale wine business in addition to expanding the original operations. In 1892, through a combination of fortuitous circumstances, Heublein invented the bottled cocktail. From this time until the start of national Prohibition, Heublein's principal business was the production and sale of distilled spirits.

In 1907 Heublein began importing Brand's A-1 steak sauce and later, when World War I disrupted the importation, acquired the manufacturing rights to the product in the United States. When Prohibition forced Heublein to close down its liquor plant in 1920, the company transferred key personnel to food operations. Until the repeal of Prohibition in 1933, A-1 steak sauce was Heublein's principal product.

In 1939 John Martin, Heublein's president and one of the company's principal stockholders, acquired the rights to Smirnoff vodka from Rudolph Kunett. Although Heublein sold only 6,000 cases of Smirnoff that year, a carefully planned promotional campaign, which was put into operation immediately after World War II, aided in boosting the sales of Smirnoff to over one million cases per year by 1954. As the vodka market expanded, Heublein introduced Relska vodka in 1953 and Popov in 1961, so as to have entries in the middle- and low-price segments of the market. Although Smirnoff's remained Heublein's principal product from 1959, when it accounted for over 67% of sales, to 1965, when it accounted for 51% of sales, Heublein began in 1959 to diversify its product line and to expand its international operations.

Heublein used both internal growth and acquisitions to broaden its product line. In 1960 it began a campaign to increase the sales of its bottled cocktails by introducing new kinds of cocktails and promoting the entire line more heavily. As Heublein's sales began to increase, other distillers, principally Distillers Corporation, began to market their own cocktails. By 1965 sales of bottled cocktails exceeded 850,000 cases a year, more than double the 1960 sales, and Heublein still claimed 55% of the market.

In 1961 Heublein made two acquisitions that strengthened its specialty food line. Timely Brands, which manufactured and marketed a complete line of ready-to-use, home dessert decorating products including Cake-Mate icing and gels, was acquired in June. In July Heublein acquired Escoffier, Ltd. of London, makers of 23 famed gourmet sauces and specialties.

Heublein made two more acquisitions during this period, both of which were designed to broaden and strengthen its liquor line. In April 1964 Heublein acquired Arrow Liquors Corporation for an estimated cost of $5.7 million. Arrow's principal products were its line of cordials, including Arrow peppermint schnapps and Arrow blackberry brandy, and its domestically bottled, bulk-imported scotch, Mc-

Master's. According to Edward Kelley, the three principal reasons for the Arrow acquisition were that Heublein expected the cordial and scotch markets to grow in the future, that Arrow had products that were among the leaders in these markets in the control states, and that Arrow had a small but extremely competent management.

In January 1965 Heublein acquired Vintage Wines for approximately $2.2 million. Vintage, whose sales were about $4 million at the time of the acquisition, was integrated with the Heublein Liquor Division. Vintage's principal product was Lancers Vin Rosé, an imported Portuguese wine that accounted for about 50% of the company's sales.

The expansion in Heublein's international operations consisted primarily of the establishment of franchise operations in 21 additional foreign countries, which raised the number of such operations from 11 in 1959 to 32 in 1965.

Company Operations

Financial situation. During the 1965 fiscal year, Heublein earned $7.4 million on sales of $166 million, which represented roughly a 19% return on stockholders' equity. Between 1959 and 1965, Heublein's sales growth, profit growth, and return on equity far exceeded the average of the four major distillers (see *Table A*). In addition, even though Heublein was spending nearly twice as much (as a percentage of sales) on advertising as the average of the four major distillers and had increased the company's dividend/payout ratio to 50% of earnings, the company had a cash flow of $8.6 million in 1965, about 22% on equity, which compared favorably with the 9% average of the four major distillers.

Product line. At the end of 1965 Heublein was marketing well over 50 products through its four divisions. While vodka was the company's principal product, accounting for 62% of 1965 sales, the company's product base had been broadened considerably since 1960 by acquisitions, internal growth, and new marketing agreements (see *Table C*). Heublein's product-line strategy was to market high-quality consumer products, which provided the high margins necessary to support intensive advertising. Heublein aimed its promotions of these products at the growing, prosperous, young-adult market. The company was also interested in phasing out some of its less profitable lines whenever possible.

The liquor products division accounted for over 80% of Heublein's 1965 sales. Its principal product was Smirnoff vodka, the fourth largest selling liquor brand in the United States in 1965, with estimated annual sales of 2.3 million cases. Company officials expected that Smirnoff, with its faster rate of growth, would move ahead of the third-place brand (Canadian Club, 2.4 million cases) and the second-place brand (Seagram's VO, 2.5 million cases) within three years.

In 1965 Smirnoff had 23% of the total vodka market and outsold the second-place vodka

Table C
Sales Mix for Selected Years, 1950–1965

Year	*Smirnoff Vodka*	*Other Vodka*	*Total Vodka*	*Other Alcoholic Beverages*	*Food*	*Total*
1965	51%	11%	62%	30%	8%	100%
1964	58	12	70	21	9	100
1963	62	12	74	16	10	100
1962	63	11	74	16	10	100
1961	64	11	75	19	6	100
1960	67	9	76	18	6	100
1955	61	2	63	32	5	100
1950	27	–	27	63	10	100

Source: Heublein records

brand by over four to one. In addition, Smirnoff was the only premium-priced vodka on the market in 1965, since the wholesale price of Wolfschmidt had been lowered in 1964 in an effort to stimulate sales. After considering this action, Hart decided the appropriate response was to raise Smirnoff's wholesale price $1 per case and to put the additional revenue into advertising. Although Wolfschmidt's sales more than doubled, this increase appeared to come from the middle-priced segment of the vodka market, since Smirnoff's sales also increased 4% over the previous year and were running over 10% ahead in 1966. Smirnoff also appeared to be immune to the spread of the hundreds of private-label vodkas, since, according to company officials, these products obtained their sales from the 15% to 30% of the vodka market that was price conscious.

As a result, many industry observers expected Smirnoff to dominate the vodka market well into the future, particularly since Smirnoff could, on the basis of its sales volume, afford to spend $7 million to $8 million on advertising, while its closest rival could afford to spend only $2 million before putting the brand into the red.[4]

Relska, a medium-priced vodka, and Popov, a low-priced vodka, were produced and sold primarily to give Heublein's distributors a full line of vodka products. They accounted for 11% of company sales in 1965. They were cheaper to produce than Smirnoff but were not as smooth to the taste, according to company officials.

Heublein bottled cocktails sold an estimated 500,000 cases in 1965, about 55% of the bottled cocktail market. Nevertheless, Heublein was beginning to receive competition from the national distilling companies, particularly Distillers Corporation, whose U.S. subsidiary, Seagram, was marketing a similar line. Hart, however, welcomed this competition. He commented to the Los Angeles Society of Security Analysts in 1965:

> We believe the idea of bottled cocktails has not been completely sold to the American public. We were therefore delighted when we learned that one of the major companies in the liquor industry was introducing a new line of cocktails and that there would be heavy expenditures in advertising and merchandising to promote their usage to the public.[5]
>
> We are of the opinion that, as the cocktail market expands, our share will decrease, but Heublein cocktails will continue to be the leader and our cases will show remarkable increases.

Hart explained that distribution was one of the principal reasons why Heublein would keep its number one position. "We secured distribution in 1960 when the other companies weren't too interested in cocktails. Since a distributor will usually carry only two or three lines, this means that he will have Heublein and Calvert or Heublein and Schenley: in other words, Heublein and somebody else. . . . In addition to being first, Heublein's wide line will also help us get and maintain distribution." In 1965 Heublein's bottled cocktail line included manhattans, vodka sours, extra dry martinis, gin sours, whiskey sours, side cars, vodka martinis, daiquiris, old-fashioneds, and stingers.

During 1964 the liquor products division reintroduced Milshire gin. For years Milshire had been a regional gin selling about 100,000 cases a year. However, in 1963 the promotional budget was deemed sufficient to devote some real attention to Milshire. To prepare for this, the old inventory was sold off, the product was reformulated, and the package was redesigned. The principal difference in the product was that its botanical and aromatic content was lowered by filtering it through activated charcoal in a process similar to that used to make Smirnoff. The net effect was to make the gin "lighter." Sales for 1964 increased to 150,000 cases, a significant jump but still very far behind the 2.1 million cases of Gordon's, the leading brand.

In 1966 Heublein reached an agreement with Tequila Cuervo S.A. to be the exclusive U.S. marketer of José Cuervo and Matador tequilas and a cordial based on the same spirit. Heublein planned to market these products on a nationwide basis through the Liquor Products Division, which also marketed Harvey's sherries, ports, and table wines; Bell's scotches; Gibley's Canadian whiskeys; Byrrh aperitif wine; and the products of Vintage Wines, Inc.

4. Roger D. Bensen, *Heublein, Inc.*, Glore Forgan, Wm. R. Staats Inc., December 1965, p. 25; in 1963, according to the *Liquor Handbook*, Heublein spent $1.4 million to advertise Smirnoff, while total advertising for all other vodka brands during the same year was $1.2 million.

5. Heublein spent $2 million advertising its line of bottled cocktails in 1965. Seagram spent $1.5 million advertising its Calvert line the same year.

The Arrow division accounted for about 10% of Heublein's sales in 1965. The division's principal products were Arrow cordials, liqueurs, and brandies, and McMaster's scotch. Though Arrow's distribution system was particularly strong in the control states, its distribution in the open states was strengthened in 1965 when Heublein discontinued the production of its line of Heublein cordials and substituted the Arrow line.

Although the sales of the food division more than doubled between 1961 and 1965, they accounted for only 8% of the company's 1965 sales. Nevertheless, A-1 steak sauce was the company's number two profit producer in 1965, second only to Smirnoff vodka. Other food products included Cake-Mate icings and gels, Escoffier sauces, Grey-Poupon mustard, and Maltex and Maypo cereals. In 1965 Heublein reached an agreement with the Costal Valley Canning Company of California to distribute and market Snap-E-Tom Tomato Cocktail, a tomato juice flavored with onion and chili pepper juices. It was designed for the premeal juice and the cocktail mixer markets, both of which had high profit margins.

Marketing. Heublein's unique advertising and promotion policies and campaigns set Heublein apart from the other liquor companies (see *Table D*). Heublein considered liquor to be a branded consumer product and viewed itself as a marketer of high-quality consumer products rather than as a liquor company. As a result, Heublein developed intensive advertising campaigns to sell its products for the growing, affluent young-adult market, since it believed it was easier to get a new customer in this market than to get a 40-year-old scotch drinker to switch to vodka. Because of the importance attached to advertising, Heublein spent 10.6% of sales for advertising in 1965, nearly double the expenditure of Distillers Corporation.

In addition, Heublein was an aggressive innovator among liquor industry advertisers. In the 1950s industry self-regulation prohibited depicting a woman in an advertisement for a liquor product. In 1958 Heublein advised the Distilled Spirits Institute that it believed this ban on the portrayal of women was "obsolete, hopelessly prudish, and downright bad business." Finally, the DSI agreed, and Heublein became the first liquor company to portray women in its ads under the new DSI self-regulation, an advertising practice later followed by nearly every major distiller. Heublein also pioneered a change in DSI regulations to permit liquor advertising in Sunday supplements. At the end of 1965, Heublein was pushing for the use of liquor advertisements on radio and TV similar to beer and wine advertisements.

Another unique feature of Heublein's marketing was its promotions, which were designed to appeal to the young-adult group and used celebrities and off-beat approaches to gain attention (see *Figure D*). An example of this approach was the Smirnoff Mule promotion launched in May 1965. The promotion, Heublein's largest for a single drink, was designed to catch discotheque popularity on the upswing. The total investment was about $2 million for advertising, merchandising, and sales promotion. The *New York Times* commented:

> Included in the Smirnoff advertising mix are a drink, called the Smirnoff Mule; a song and dance, called simply The Mule; a recording called Skitch Plays "The Mule"; a

Table D
Advertising Expenditures of Major Liquor Companies, 1965

	$ Millions		*Advertising as a % of Sales*
	Advertising	*Sales*	
Distillers Corp. Seagram	$43,750	$762,520	5.7%
Schenley Industries	23,100	380,200	6.1
National Distillers & Chemical	19,668	810,900	2.4
Hiram Walker–Gooderham & Worts	17,750	498,174	3.6
Heublein	17,495	165,522	10.6

Source: *Advertising Age*, January 3, 1966, p. 46.

Figure D
Smirnoff Mule Advertisement

Source: Company files

copper-colored metal mug in which to drink the Smirnoff Mule, and a recent phenomenon called the discotheque. . . . [Heublein's advertising agency] the Gumbinner-North Company has recruited such vodka salesmen as Skitch Henderson, Carmen McRae, and Killer Joe Piro to put it over. . . . In addition to Smirnoff ads, The Mule will be featured in local advertising by the 7-Up people.[6]

6. Walter Carlson, "Advertising: Smirnoff Harnesses the Mule," The *New York Times*, June 27, 1965.

Distribution. Heublein sold its products directly to state liquor control boards in the 18 control states and to approximately 235 wholesale distributors in the 32 open states and the District of Columbia. Food products were sold through food brokers and wholesalers. It was Heublein's policy to strive to create mutually profitable relationships with its distributors. For example, one of the reasons for the creation of Popov vodka was to give Heublein's distributors a low-priced vodka brand to sell.

International operations. At the end of 1965 Heublein was involved in three types of overseas activities. The largest and most important was its licensing operation. Distillers in 32 foreign countries, including Austria, Denmark, Greece, Ireland, New Zealand, South Africa, and Spain, were licensed to manufacture and market Smirnoff vodka. When selecting a franchise holder, Heublein looked for a local distiller who had good production facilities and who was a good marketer in his country, believing that this policy allowed Heublein to get established faster than if it tried to set up its own plant and also that it improved relations with the local government.

Under these franchise agreements, the distiller produced the neutral spirits in the best way possible in his country. To maintain quality control, however, Heublein installed and owned the copper filtration units and shipped the charcoal to these locations from Hartford. This was done at cost. The contracts called for a license fee (about 10% of sales) and also stipulated that certain amounts be spent by the franchisee for advertising. Usually, during the first three or four years, Heublein would add its 10% license fee to these advertising funds in order to help build up the business. Plans were under way at the end of 1965 to begin operations in six more countries, including Ecuador, India, and Nigeria.

Heublein also exported Smirnoff, primarily to U.S. military bases overseas. In addition, in 1965 Heublein opened an operation in Freeport, Jamaica, to produce Smirnoff and other Heublein liquor products and to market these products to customers, such as ship's chandlers and diplomatic agencies, who could purchase tax-free liquor.

Between 1961 and 1965 Heublein's export sales increased 99%, royalties from licenses 145%, and profits from international operations 458%. In 1965 net export sales stood at $1.2 million and profits before taxes from international operations, including license fees, were $880,000.

Production. At the end of 1965 Heublein owned and operated three plants throughout the United States, with an annual capacity of 20 million wine gallons for all product lines, and was building a plant in Detroit to replace the old Arrow plant. The plant was to cost $4.5 million and to have an annual capacity of 5.5 million wine gallons. When completed, it would give Heublein a total annual capacity of 25.5 million wine gallons. All of Heublein's plants were highly automated. (Heublein had about 975 employees in 1965, of whom slightly less than half were hourly employees. In 1965 labor costs were only 3% of the total cost of sales.)

Heublein did not produce the grain neutral spirits for its gin and vodka production but rather purchased these requirements on contract and the open market from four distillers. The company maintained facilities in the Midwest for the storage of 8 million proof gallons, however, in case none of these suppliers could meet Heublein's stringent quality requirements. At 1965 consumption rates, this represented about a year's supply.

According to Heublein, even the high-quality grain neutral spirits it received from its suppliers contained too many impurities for direct use in Smirnoff. The first step in Smirnoff production was, therefore, to redistill these grain neutral spirits. At the end of the redistillation, the alcohol was 192 proof. It was then blended with distilled water to reduce the mixture to 80 proof. The mixture was then filtered slowly through 10 copper tanks containing over 14,000 pounds of activated charcoal. The filtering process required eight hours. According to company officials, it was during this process that the vodka became smooth and mellow and acquired its mild but distinctive taste. The only remaining step was to bottle the finished product, since vodka requires no aging.

Heublein also redistilled the grain neutral spirits used in the production of its charcoal-filtered Milshire gin. However, the company did not redistill the liquors (purchased on the open market) used in the production of Heublein cocktails.

Most of the food products were manufactured at Hartford or at the plant in Burlington, Vermont. Heublein insisted on the same high-quality standards in the purchase of raw materials and the production of its food products that it required in its liquor production.

Proposed Hamm Acquisition

Early in the fall of 1965, Heublein's top management was seriously considering the possible acquisition of the Theo. Hamm Brewing Company. They were particularly interested because they felt Hamm could profit immensely from what they felt was Heublein's major strength—the ability to market a consumer

product extremely well. If the acquisition were consummated, Heublein would become the first company to engage in the production and sale of both beer and liquor.

Under the proposed agreement Heublein would acquire all of the outstanding shares of Hamm's common in exchange for 420,032 shares of Heublein's 5% preferred and 200,031 shares of Heublein's 5% convertible preferred. Both preferreds had a par value of $100; the latter was convertible into three shares of Heublein common, subject to certain provisions against dilution of earnings. Although Hamm's stock was held by a family group and did not have a market price, Heublein's board estimated that the aggregate fair value was in excess of $62 million, or book value (see *Exhibit 3*). The proposed agreement stipulated that each class of preferred would have the right to elect one person to Heublein's board. In addition, it was provided that the $25 million of securities indicated on the Theo. Hamm Brewing Company consolidated balance sheet as of September 30, 1965, would be liquidated and used to buy out dissident Hamm stockholders prior to the acquisition by Heublein. This would have the effect of reducing Hamm's working capital and stockholder equity by about $25 million before the purchase.

Hamm's history and competitive position. Hamm was a family-owned brewing company. During the five years preceding the proposed acquisition, sales and profits had remained relatively stable (see *Exhibits 4* and *5*). However, since industry sales had increased slightly more than 11% during this period, Hamm's market share had declined from 4.5% to 3.7%. In addition, Hamm's return on sales had lagged behind that of the industry leaders (see *Table E* and *Exhibit 6*).

Hamm sold three brands of beer at the end of 1965: Waldech (premium price), Hamm's (premium and popular price), and Buckhorn (lower price). The 1964 sales breakdown among these brands had been 17,800 barrels for Waldech, 3,624,700 barrels for Hamm's, and 57,800 barrels for Buckhorn. (A barrel is equivalent to 31 U.S. gallons.) In addition, in 1964 Hamm had produced some beer for sale to the Schaefer Brewing Company under the Gunther brand.

In 1965 Hamm's beer was sold in 31 states and the District of Columbia, with most sales concentrated in the Midwest, West, and Southwest. Hamm relied exclusively for its distribution on 479 independent wholesalers, most of whom carried other brands of beer. Although these wholesalers could terminate their relationship with Hamm at will, none of them accounted for more than 2.5% of Hamm's 1964 sales.

According to some industry observers, Hamm's four breweries were among its principal assets. Three of these were owned outright, while the fourth was leased. The location and annual productive capacity of each of these plants was as follows:

Location	*Barrels per Year*
St. Paul, Minn.	2,550,000
San Francisco, Calif.	1,000,000
Los Angeles, Calif.	500,000
Houston, Tex. (leased)	450,000
	4,500,000

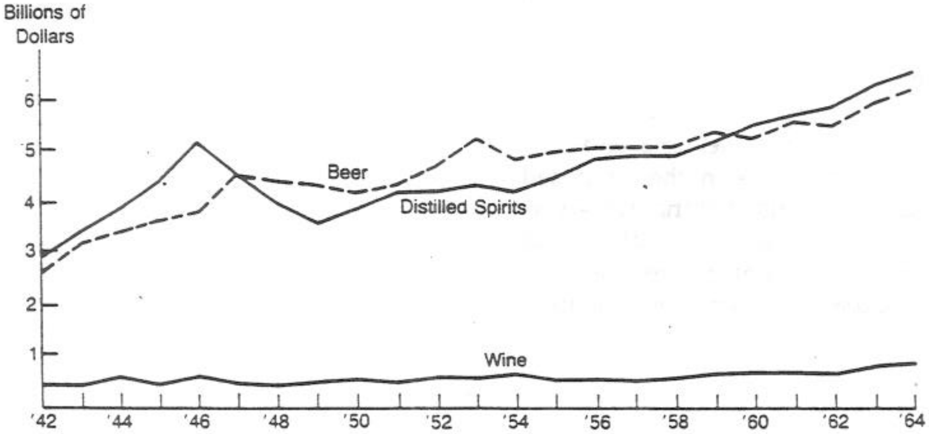
According to industry estimates, the cost of replacing Hamm's 1965 capacity would be about $135 million, or more than double the proposed purchase price. This estimate was based on an industry rule of thumb, which set the cost of

Table E
Leading Brewers—Returns on 1964 Sales

	Total Revenues ($000)	*Pretax Net ($000)*	*Profit Margin (%)*	*Barrels Sold (000)*	*Pretax Returns/ Barrel*
Anheuser-Busch	$491,384	$39,312	8.00	10,235	$3.84
Schlitz	311,394	28,277	9.08	8,266	3.42
Pabst	227,610	20,421	8.97	7,444	2.74
Falstaff	211,943	13,604	6.42	5,815	2.33
Hamm	125,602	8,657	6.89	3,719	2.33

Source: Company annual reports

Figure E
Consumer Expenditures on Alcoholic Beverages, 1942–1964



Source: Gavin Jobson Associates, Inc., *The Liquor Handbook, 1965*; cited by Glore Forgan, Wm. R. Staats Inc., in *Heublein, Inc.*, December 1965.

Table F
Advertising Expenditures of Major Brewers, 1965

	Advertising ($000)	*Sales ($000)*	*Advertising as a % of Sales*
Jos. Schlitz Brewing	$34,200	$311,375	11.0%
Anheuser-Busch	32,500	491,384	6.6
Pabst Brewing	15,900	227,610	7.0
Carling Brewing	15,500	412,306	3.8
Falstaff Brewing	15,000	211,943	7.0

Source: *Advertising Age*, January 3, 1966, p. 46.

new plant construction at $30 to $35 per barrel at the end of 1965.

Like Heublein, Hamm purchased most of the raw materials needed for its production—malt, barley, hops, and corn grits—from various independent suppliers. About one-fourth of its malt and hops requirements were met by wholly owned subsidiaries.

The brewing industry. At the end of 1964 the beer market was approximately the same size as the distilled spirits market, about $6.4 billion a year (see *Figure E*). In addition, from 1960 to 1964 the beer market had grown at approximately the same annual rate as the liquor market, about 2.5%. Per capita beer consumption had increased moderately during the period.

Since people began consuming beer at a younger age than they did liquor, industry observers expected beer consumption to increase as much as, if not more than, liquor consumption through 1970. Most of this increase was expected to be in the sale of packaged beer, since the sale of draft beer had decreased from 22% of total beer sales in 1955 to 19% in 1964.

The same observers felt that brand loyalty was not as strong for beer as for liquor. Nevertheless, the economies of high-volume production and the use of costly advertising (see *Table F*) seemed to be causing a gradual concentration of the beer industry; the number of breweries operated in the United States decreased from 329 to 211 between 1953 and 1963. Moreover, the percentage of sales accounted for

by the largest brewing companies had been on the increase (see *Table G*).

Recommendation

Hart knew that the negotiations with Hamm had been proceeding for some time and that any significant modifications in the proposed terms were unlikely. He also felt that there was little additional information available that would be important and that the Heublein directors would be expecting his recommendation soon.

Table G
Market Share of Major Brewers (%)

	Top 25	*Top 10*
1964	83.7	57.7
1963	82.2	56.8
1962	79.9	55.0
1961	77.4	52.8
1960	75.1	51.4
1959	73.8	50.0
1958	70.5	45.9
1957	69.2	45.2
1956	67.5	44.4
1955	64.3	42.7
1954	62.1	40.8
1953	61.3	40.1
1952	60.2	40.8
1951	57.5	39.2

Source: Research Company of America

Exhibit 1
Consolidated Balance Sheets, Selected Years, 1955–1965 ($ in thousands)

	Years Ending June 30				
	1955	*1960*	*1963*	*1964*	*1965*
Assets					
Current assets					
Cash	$2,298	$3,925	$2,744	$3,357	$3,338
Time deposits			6,000	1,750	
Marketable securities	9	4,883	1,000		4,048
Investment in whiskey certificates		593	1,069	150	
Accounts and notes receivable	5,157	12,426	17,835	18,668	19,010
Inventories	5,825	8,269	9,127	13,347	16,323
Prepaid expenses	297	382	356	325	548
Total current assets	$13,586	$30,479	$38,130	$37,597	$43,267
Long-term assets					
Property, plant and equipment—net	$3,254	$5,793	$6,363	$7,339	$7,502
Deferred charges, other assets and goodwill	223	416	1,068	3,659	5,383
Total long-term assets	$3,477	$6,209	$7,431	$10,998	$12,885
Total assets	$17,063	$36,688	$45,561	$48,595	$56,152
Liabilities and Stockholders' Equity					
Current liabilities					
Notes payable to banks	$2,000				
Accounts payable	687	$1,933	$2,078	$2,417	$3,584
Federal income tax	531	2,857	3,607	4,129	4,701
Accrued liabilities	513	2,688	4,044	5,175	5,774
Cash dividends payable	98	299	733	721	986
Long-term debt due within one year	301	631	777	850	1,013
Total current liabilities	$4,129	$8,408	$11,239	$13,292	$16,059
Long-term liabilities					
Long-term debt due after one year	$4,699	$5,388	$3,239	$2,416	$1,403
Deferred federal income tax			154	248	316
Minority interest				272	
Total long-term liabilities	$4,699	$5,388	$3,393	$2,936	$1,719
Stockholders' equity	$8,235	$22,892	$30,929	$32,368	$38,374
Total liabilities and stockholders' equity	$17,063	$36,688	$45,561	$48,595	$56,152

Source: Heublein records

Exhibit 2
Consolidated Income Statements, Years Ending June 30, 1955–1965 ($ thousands)

	1955	*1956*	*1957*	*1958*	*1959*	*1960*	*1961*	*1962*	*1963*	*1964*	*1965*
Net sales	$37,222	$68,543	$82,064	$87,839	$87,647	$103,169	$108,281	$116,142	$121,995	$135,848	$165,595
Cost of sales[a]	29,503	53,219	63,234	67,231	67,276	78,028	80,419	85,793	89,500	99,575	121,503
Gross profit	$7,719	$15,325	$18,830	$20,608	$20,372	$25,140	$27,862	$30,349	$32,495	$36,273	$44,092
Expenses											
Selling and advertising	$4,650	$8,013	$10,617	$12,613	$12,710	$14,276	$16,089	$16,444	$18,271	$20,477	$24,551
Administrative and general	1,479	2,288	2,699	2,822	2,561	2,783	3,205	4,111	3,710	3,485	4,257
	6,130	10,301	13,315	15,434	15,271	17,060	19,293	20,555	21,981	23,962	28,808
	1,590	5,024	5,515	5,176	5,100	8,080	8,569	9,794	10,514	12,312	15,284
Other[b]	189	316	407	519	638	293	168	199	(339)	(18)	(112)
	1,401	4,708	5,109	4,654	4,462	7,788	8,401	9,595	10,852	12,330	15,397
State and federal income taxes	733	2,531	2,697	2,524	2,399	4,232	4,587	5,188	5,830	6,516	8,021
Net income	$667	$2,177	$2,411	$2,130	$2,063	$3,556	$3,814	$4,407	$5,022	$5,814	$7,376

Source: Heublein records

a. Includes federal excise taxes on the withdrawal of distilled spirits from bond. These totaled $90 million for the fiscal year 1965.

b. Interest income, interest expense, and miscellaneous.

Exhibit 3
Hamm Brewing Company—Consolidated Balance Sheets ($ thousands)

	Nov. 30, 1964	*Sept. 30, 1965*
Current assets		
Cash	$3,475	$3,153
Certificates of deposit	2,000	500
Commercial paper and marketable securities (at cost)[a]	26,560	24,044
Accounts receivable (net)	5,452	7,959
Inventories	5,352	6,479
Prepaid expenses	898	891
Total current assets	$43,737	$43,027
Investments and other assets	6,467	6,536
Property, plant, and equipment (net)	26,381	26,930
	$76,585	$76,493
Current liabilities		
Trade accounts payable	$2,639	$2,926
Salaries and wages	1,207	1,304
Customers' deposits	932	1,151
Miscellaneous accounts payable and accrued expenses	470	1,301
Taxes other than taxes on income	2,038	2,299
Federal and state taxes on income	2,657	2,559
Dividends payable	1,538	660
Sinking fund deposits due in one year	100	100
Total current liabilities	$11,580	$12,302
8% debenture bonds	1,400	1,400
Stockholders' equity		
Capital stock	55,083	26,432
Capital surplus		26,273
Earned surplus	8,521	10,086
	$76,585	$76,493

Source: Heublein acquisition study
a. The market value of these securities was $28.1 million in 1964 and $25.7 million in 1965.

Exhibit 4
Hamm Brewing Company—Consolidated Income Statements ($ thousands except per share data)

Years Ending November 30	1960	1961	1962	1963	1964	10 Months Ended September 30 (unaudited) 1964	1965[d]
Revenues							
Sales less allowances	$119,881	$115,874	$114,885	$119,584	$124,233	$106,109	$109,449
Interest	161	240	270	575	958	748	941
Dividends	81	62	50	51	61	58	42
Other	283	95	175	196	351	301	359
	$120,407	$116,272	$115,380	$120,405	$125,602	$107,217	$110,791
Costs and Expenses							
Cost of goods sold[a]	$89,843	$86,314	$86,595	$90,878	$95,388	$81,004	$84,597
Selling, delivery, advertising, general and administrative expenses	16,263	17,065	16,200	18,534	21,423	18,196	19,026
Interest							
Long-term debt	235	164	120	120	120	100	100
Other	8	159	2	16	13	12	–
	$106,349	$103,702	$102,918	$109,548	$116,945	$99,312	$103,723
Earnings before taxes on income	$14,057	$12,570	$12,462	$10,857	$8,657	$7,905	$7,068
Taxes on Income							
Federal	$6,750	$6,150	$6,100	$5,100	$3,900	$3,550	$3,000
State	450	400	400	275	300	275	225
	$7,200	$6,550	$6,500	$5,375	$4,200	$3,825	$3,225
Net earnings (excluding the operations of the eastern division and related distributing subsidiaries)	$6,857	$6,020	$5,962	$5,482	$4,457	$4,080	$3,843
Loss on operations of eastern division and related distributing subsidiaries less applicable income tax benefits[b]	1,092	1,717	2,124	1,408	–	–	–
Net earnings	$5,765	$4,303	$3,838	$4,074	$4,457	$4,080	$3,843
Preferred stock dividend requirements	210	210	210	210	210	175	142
Earnings applicable to common stock	$5,555	$4,093	$3,628	$3,864	$4,247	$3,905	$3,701
Per common share (dollars)							
Earnings applicable to common stock[c]	$2.14	$1.57	$1.40	$1.49	$1.63	$1.50	$1.40
Cash dividends declared			.40	.95	1.25	.50	.75

Source: Heublein acquisition study

a. Includes federal and state excise taxes of between $32 and $38 million for each of the above periods.

b. In 1960, the company acquired brewing facilities in Baltimore, Maryland, which were sold in 1963 for $6 million, the approximate net carrying amount of the facilities. Applicable income tax benefits ranging between $1.2 and $2.1 million have been netted against loss on operations of eastern division and related distributing subsidiaries for the years 1960–1963 inclusive.

c. Based on the number of shares outstanding at the end of each period as adjusted for the recapitalization during the year ending November 30, 1961.

d. Earnings for the 10 months ending September 30, 1965, were adversely affected by nonrecurring legal and centennial expenses aggregating to approximately $400,000.

Exhibit 5
Heublein and Hamm—Pro Forma Combined Income Statements ($ thousands except per share data)

Years Ending Heublein, June 30 Hamm, November 30	*1960*	*1961*	*1962*	*1963*	*1964*	*10 Months to Sept. 30, 1965*
Net sales	$223,050	$224,156	$231,027	$241,579	$260,082	$249,056
Cost of sales	167,872	166,732	172,389	180,378	194,963	187,059
Selling, general and administrative expenses	33,323	36,359	36,755	40,515	45,385	43,164
Other income (deductions)						
Interest and dividend income	352	417	444	865	1,287	1,217
Interest expense	(560)	(595)	(363)	(344)	(342)	(215)
Miscellaneous—net	198	85	93	503	308	320
	(10)	(93)	174	1,024	1,253	1,322
Income before income taxes	21,845	20,972	22,057	21,710	20,987	20,155
Provision for income taxes	11,432	11,137	11,688	11,205	10,716	9,966
Net income before loss on discontinued operations of Hamm	10,413	9,835	10,369	10,505	10,271	10,189
Loss on discontinued operations of Hamm, less applicable income tax benefits	1,092	1,717	2,124	1,408	–	–
Net income	9,321	8,118	8,245	9,097	10,271	10,189
Deduct pro forma adjustments						
Interest and dividend income	219	275	290	591	981	950
Interest expense	1,209	983	975	501	122	85
Income taxes	(738)	(638)	(652)	(549)	(496)	(418)
	690	620	613	543	607	617
Pro forma net income	8,631	7,498	7,632	8,554	9,664	9,572
Preferred dividend requirements						
Heublein:						
5% preferred stock	2,100	2,100	2,100	2,100	2,100	1,750
5% convertible preferred stock	1,000	1,000	1,000	1,000	1,000	833
	3,100	3,100	3,100	3,100	3,100	2,583
Pro forma earnings applicable to common stock	$5,531	$4,398	$4,532	$5,454	$6,564	$6,989
Pro forma earnings per share (dollars)						
Assuming no conversion of convertible preferred stock	$1.15	$.91	$.93	$1.12	$1.37	$1.43
Assuming full conversion of convertible preferred stock	1.21	1.00	1.01	1.18	1.40	1.43
Actual Heublein earnings per share[a]	.74	.79	.91	1.03	1.21	1.30

Source: Heublein acquisition study

a. Heublein shares outstanding in June of 1965, 4.9 million; approximate market price/share in 1965 (to September) $26–27.

Exhibit 6
Beer: Larger Markets, Tougher Competition

The bigger it gets, the rougher it gets. That sums up the brewing industry, which has just had its best year ever. But no one brewer had an easy time of it, and the competition will get even stiffer in the years ahead.

Kenneth Ford, managing editor

No one in the brewing industry had anything but kind words last week for the nation's growing number of young adults.

Not only were they quaffing their share of brew and more besides, but even more significant, they appeared willing to cast aside some old-fashioned concepts about beer being a "blue-collar" drink.

For the nation's 190 brewers (four fewer than the year before) the moral was that patience pays off. All during the long, dry decade of the Fifties the industry watched total consumption lag behind population growth and per capita consumption remain static at a low level. Brewers pinned their hopes on the vast crop of war babies of the Forties, hoping that when they reached drinking age they would set off a beer boom, but also fearing they might move from the innocence of Coke to the decadence of martinis in one easy step.

They didn't. When the 1963 figures were totaled up at this time last year, there were clear signs that the brewing industry was on the move at last. No one outside the industry realized how fast it was moving until the 1964 totals came in last month.

The results: total sales (consumption) climbed to 98.5 million barrels, up 5% from 1963's 93.8 million barrels. Per capita consumption, the more meaningful measure of marketing effectiveness, jumped to 15.7 gallons, up 2.6% from 1963's 15.3 gallons. Both gains were the best year-to-year increase posted by the industry since 1947.

It is a certainty that the industry will cross the 100-million barrel barrier in 1965. The only question is whether it will reach 101 million or 102 million barrels. No one will be unhappy if it doesn't go that high—the industry's most optimistic forecasters hadn't expected it to reach the 100-million barrel level until 1967.

But though the overall industry outlook is sudsy, neither leaders nor laggards are finding it easy selling.

Competition has never been fiercer. The nation's top ten brewers have staked out 57.7% share of the total market, selling 56.6 million barrels of that 98.5 million total. The next 14 ranking brewers take 25.4% of the total, or 25 million barrels. All together, the top 24 brewers, each doing better than one million barrels apiece, account for 82.9% of total sales, some 81.6 million barrels.

But even what would be a normally respectable gain was not enough to hold the previous year's position, much less advance, in the top 24 standings.

Losses and Gains

Carling dropped in 1964 from 4th to 5th; Hamm from 7th to 8th; Rheingold from 10th to 11th; Lucky Lager from 13th to 16th; Pearl from 17th to 18th; Narragansett from 19th to 21st; and Jackson from 23rd to 24th. Yet five had made sales gains—Carling's posted a 1.7% increase; Rheingold a 3.1% increase; Pearl a 5.4% increase; Narragansett a 2.8% increase; and Jackson a 2.2% increase.

The leading brewers had set such a blistering pace that merely running to keep up just wasn't fast enough.

Exhibit 6 (continued)

First-place Anheuser-Busch (Budweiser–Busch Bavarian–Michelob) achieved a 10.1% gain that carried it across the 10-million barrel level, an industry record, and gave it a 10.5% share of the total market. Anheuser-Busch's (A-B) phenomenal performance was the culmination of marketing programs set in motion as long as a decade ago. Basically, these concentrated on development of marketing executives, achieving the best possible communication with its 900 wholesalers throughout the country and expanding plants into growing markets. (Its new Houston brewery will be ready next year.)

Though A-B is one of the heaviest advertisers in the industry, it makes only evolutionary changes in its advertising program from year to year. "Where There's Life There's Bud" (1963) became "That Bud, That's Beer" (1964) and now becomes "It's Worth It, It's Budweiser" (1965).

Expansion-minded Schlitz, eyeing the heavier-beer-drinking Canadian market (per capita consumption 16.4 gallons) tried to migrate north by buying control of Canada's Labatt Brewing, but found itself ensnarled in antitrust actions and other legal complications. The time and attention it had to devote to these were reflected in only a 5.3% gain, in contrast to 1963's 13% gain.

Another 11.6% gain like the one Pabst made last year might well knock Schlitz out of second place. And fast-rising Falstaff is a factor that Schlitz and Pabst marketing executives both must reckon with in the year ahead.

Falstaff surprised everyone by clipping Carling out of fourth place in the brewing industry. Carling had made sixteen consecutive sales gains that brought it up from 19th in the industry and was generally conceded to be the brewer to watch. Controlled by Canadian entrepreneur E. P. Taylor, its marketing strategy is based on two rules: build plants where the markets are growing (it now has nine in the U.S.) and advertise heavily.

But it was Falstaff's ambition and innovation that carried it ahead. It markets only one brand of beer, Falstaff, in 32 states westward from Indiana. These states have 45% of the nation's population but consume less than 45% of total beer production.

A Competitor to Respect

"If we were in the other 18 states, we'd be selling 10.5 million barrels instead of 5.8 million," says George Holtman, vice president, advertising. Holtman's boast is not idle. That Falstaff is a competitor to respect is attested to by Hamm's decline of 2.5%. Both collided competitively in the Midwest generally and the Chicago market in particular. Falstaff began moving into Chicago three years ago and the 1964 figures reflect its arrival. Similarly, it began moving into the West Coast in recent years where traditional beer sales patterns are changing, too. Lucky Lager, long the leading West Coast brand, slumped 15.1%, dropping below the two-million barrel level under the impact of competition from Falstaff and other interloping brewers. Among them: the Schlitz-Burgemeister brand team, Falstaff, Budweiser, and Carling. The latter is going to build its own brewery in the San Francisco area, which should make conditions in the important California market (it accounts for about 7.5% of total consumption alone) even more competitive.

But the moral is not that the big, bad national brands come in and knock off the poor little locals. Washington-based Olympia, strong in the Northwest, and Denver-based Coors both are making significant progress on the West Coast. Olympia scored a 22.1% increase, and Coors, long the strong man of the Rocky Mountain empire, boosted advertising budgets by 11% and barged into California. Result: a 12% sales increase.

(continued on next page)

Exhibit 6 (continued)

In the big New York market, it was a locally based brewer that led the pack—Brooklyn's Schaefer Brewing. Schaefer soared to 4,250,000 barrels—up 10.1%, while Newark-based Ballantine dropped 3.9% and Rheingold, up 3.1%, slipped out of the top 10 and found its claim to being top brand in the New York metropolitan area under severe pressure.

Ballantine, long handled by the Wm. Esty Co., is now looking for a new advertising agency. Rheingold, sold by the Liebmann family to Pepsi-Cola United Bottlers, switched agencies again. In recent years it has gone from Foote Cone & Belding to J. Walter Thompson, back to FCB, and is now at Doyle Dane Bernbach. Rheingold, under the aegis of its new management, reportedly was moving ahead at year's end behind a barrage of television and radio spots.

Competition Keen in East, Too

Throughout the East, competition was similarly strong. Philadelphia-based Schmidt (Schmidt–Prior–Valley Forge) gained 13.3%, Baltimore-based National climbed 21.5%, and Manhattan-based Ruppert, strong in New England, moved ahead 22.5%. Rochester-based Genessee (up 20.2%) cemented its already strong position in upstate New York.

One result of this fierce competition was increased ad budgets. With most brewers offering what economists call "poorly differentiated products" i.e. sameness—images were the most important function in marketing. Most brewers, in *Printers' Ink*'s annual marketing survey, of course declined to give data on ad expenditures, though a few admitted increases ranging from four to six percent. However, the industry operates on a so-much-per-barrel basis in its ad budgeting. *Printers' Ink*'s study of beer advertising expenditures (October 2, 1964, page 25) found the industry average was 96 cents a barrel for the four measured media. This would put total spending in a 98.5-million-barrel year at $94.4 million in those media. This, however, is only about one-third of total expenditures. Big chunks of money go for "rights" to broadcast sports events, a staple of beer marketing. For instance, Schlitz, now building a new brewery in Texas, paid out $5.3 million for rights to the Houston Colts games.

"It's all part of becoming a new resident of the area," a Schlitz spokesman explained. "We want to get known fast and this is how you do it."

So important are sports sponsorships that they significantly influence marketing strategy. For example, Schmidt's bought the old Standard Beverage plant in Cleveland from Schaefer (which then bought the old Gunther plant in Baltimore from Hamm). Schmidt originally intended to use the Cleveland brewery to supply its markets in western Pennsylvania and western New York state and had no immediate intention of entering the northeastern Ohio market. But the opportunity arose to buy a participation in radio-sponsorship of the Cleveland Browns games. Schmidt's bought it and entered the market immediately.

Can U.S. Compete Abroad?

For the past few years, American brewers have enviously watched the success of imported European beers in the U.S. The European imports sell less than one percent of the total sold in the U.S. but their profit margins are far better than the domestic brewers achieve on a unit basis. Would the same not hold true for U.S. and Canadian beers overseas? It is also a way to rise above the cannibalistic competition in the U.S. The other way is to increase the beer consumption of the American drinker. Though 1964's 3.3% increase in per capita consumption was the best in recent years,

Exhibit 6 (continued)

the industry lags far behind the high of 18.7 gallons set in 1945 or even the post-war 18.4 gallons quaffed in 1947.

New products may help. Schlitz, Pabst, and National are now strongly promoting malt liquor brands. A-B's Michelob and Hamm's Waldech in the super-premium class are upgrading beer's image and adding a new group of customers.

But it is a packaging development that may be of the most far-reaching significance. This is the home keg of draft beer that fits neatly into the family refrigerator. In the consumption battle, beer's increase in share must come from soft drinks, coffee, tea, and such—not merely from population growth or competitors' customers.

In the decade ending in 1963, beer consumption increased only 12% while the population grew 19%. Soft drinks shot up 48%, soluble coffee 158%, and tea 20%.

The confirmed beer drinker guzzles about six quarts a week on a yearly averaged-out basis. That's about two and a half 12-ounce cans at a time.

What the industry must attract is the glass-at-a-time sipper. That's not much at a time, but there are an awful lot of them and enough sips by enough people can boost beer back near the 20-gallons-per-capita consumption level of pre–World War I days.

It will take a revolution in American beer-drinking patterns to do it, but it could happen.

Source: *Printers' Ink*, Feb. 12, 1965. Reproduced by permission.

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11.

WHARTON REPROGRAPHICS

BARGAINING STRATEGIES

Collaborative versus Competitive Approaches

Recently two executives from different companies saved their respective employers at least $1 million in legal fees and three years of uncertainty by personally negotiating an out-of-court settlement for a patent infringement suit. Almost daily the business press reports other, less dramatic examples of negotiating activity: mergers and acquisitions; labor settlements; international trade agreements; joint ventures; government contracts; the terms of product recall campaigns. And within companies, equally important deals are part of every manager's job: sales managers negotiate production schedules with plant managers; controllers negotiate overhead rates with division managers; product designers negotiate specifications with process engineers; purchasing agents arrange long-term contracts with suppliers.

Negotiation is a very common process -- and an important one. Most of the important tasks that organizations accomplish involve the exchange of information and/or material resources between different departments or divisions, or between members of the company and representatives of other organizations. These kinds of exchanges usually require managers who do not have formal power or authority over each other to work out agreements that satisfy the needs of each of the interested parties. The ability to create such agreements -- to negotiate effectively -- is increasingly being recognized as a critical managerial skill.

Negotiating skills are important largely because managers from different departments have legitimately different goals, needs, and perspectives about their joint problems. And when two or more organizations are involved, the differences are usually much greater. Senior Executives spend much of their time designing organizational structures, control systems, and other formal mechanisms that will encourage operating managers to arrive at appropriate interdepartmental and interorganizational agreements. Yet, no matter how complex they are, formal systems cannot provide routine solutions for all the problems and conflicts that arise. Thus, organizations depend heavily on their operating managers to negotiate many kinds of agreements on a problem by problem basis.

The challenge for a manager involved in a joint decision making situation is to develop and implement strategies for working with people whose needs and interests differ from his or her own. Effective negotiators need both analytical and interpersonal skills; they must be able to determine what kind of bargaining stance a particular situation calls for, and they must know how to carry out that stance as they interact with the people on the other side.

This note was prepared by Assistant Professor James P. Ware as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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This Note is the first of two that treat negotiation situations in some depth. This Note focuses on analysis -- understanding the characteristics of joint decision making situations and selecting appropriate bargaining strategies. The second note will concentrate on the personal and interpersonal skills that characterize effective negotiators, and will suggest a variety of specific tactics for improving the quality of negotiated decisions. In both Notes the perspective will be that of middle managers who engage in joint decision making on a recurring basis. Thus, the focus will be more on negotiating effectively within established systems, and less on designing formal coordination mechanisms.

Negotiating: Some Basic Definitions

In this discussion we will not limit our perspective to formal negotiations that result in signed, contractual agreements, but will consider a wide variety of joint decision making situations. For our purposes, the term "negotiation" can best be defined in terms of five basic characteristics:*

1. Two or more distinct Parties are involved.

In organizational settings we are most interested in situations where the "Parties" are functional departments or other formally designated groups. In many cases, the face-to-face negotiations are actually carried out by individuals or small teams representing the principal Parties. We shall use the term "Negotiators" and "Representatives" somewhat interchangeably to refer to the individuals who carry out the face-to-face negotiations, while the more general concept of "Party" will mean any of the individuals or groups who have a direct stake in the outcomes of the negotiation.

2. The Parties have differing interests with respect to one or more issues.

If there were no differences between the Parties, there would be no need for negotiations.

3. At the same time, however, the Parties share an interest in reaching agreement, and often have other common interests as well.

The basic factor that brings individuals and groups into negotiations is interdependence; each Party needs something that the other has or controls. This mutual need leads both Parties to believe (at least initially) that they will be better off reaching an agreement than they would be otherwise. Beyond this common interest in finding a mutually agreeable settlement, negotiating Parties often discover issues or problem areas in which their needs or goals

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*Adapted from J.Z. Rubin and B.R. Brown, The Social Psychology of Bargaining and Negotiation, New York: Academic Press, 1975.

are actually very similar. This dual presence of both common interests and conflicting interests is what makes negotiating such an important and intriguing process.

4. Thus, a negotiation involves the voluntary sharing or exchange of one or more specific resources, or the resolution of an intangible issue or issues.

A completed negotiation leaves each Party in possession of, or control of, something it did not have before. Furthermore, in the absence of other options, each Party must perceive that its payoffs exceed its costs or it would not have agreed to the settlement.

5. Finally, negotiation is generally a sequential process in which the Parties alternately present demands or proposals, and offer counterproposals, with the intention of reaching an agreement.

The negotiating relationship is a dynamic, evolving one. Negotiations involve extensive exchanges of information, coupled with a continuing evaluation of the accuracy and reliability of the other Party's statements. Negotiations also require flexibility; if a Party enters a discussion totally committed to one position and unwilling to make any concessions, the discussion could hardly be called a negotiation.

Distributive and Integrative Situations

At the broadest level we can distinguish between two types of negotiating situations: distributive and integrative. Distributive situations are those requiring agreements about how to allocate shares of a scarce resource: who gets how much. Integrative situations are those characterized by a common problem that the Parties jointly attack in search of a solution that will benefit everyone.

Game theorists use the terms zero-sum and nonzero-sum to refer to these two very different situations. In a zero-sum game, like a capital budget decision, the total payoff is fixed: what I win you lose. In a nonzero-sum game we can both win because our joint effort increases the total reward. Consider, for example, a purchasing agent and a supplier sales representative working together to expedite a raw materials requisition (at the supplier's expense) to resolve an inventory shortage. Their interests are largely in common on this issue, and when the shipment arrives both of them will look good.

If a situation is clearly either win/win or win/lose, then the choice of a bargaining strategy is relatively simple. Integrative situations call for a cooperative approach, which we will refer to as collaborative problem solving. "Zero-sum," or distributive situations, in contrast, should be approached in a competitive bargaining mode.

Collaborative problem solving is often described in terms of an open, trusting climate in which the Parties share information and ideas

relatively freely. Collaboration involves a joint effort directed at finding a solution that will be perceived as beneficial to both Parties. Typically, the collaborating Parties search for ways to increase the total payoff, with relatively little concern for who will get how much. (The underlying assumption is that a better solution will provide each Party so many benefits that allocation of those benefits will not be a problem.)

Collaborative problem solving does not smooth over or avoid differences. Rather, this strategy recognizes differences as necessary, inevitable, and even desirable in that they often generate creative tension that enhances the quality of the ultimate solution. Parties who engage in effective collaboration share norms that value reasoned, analytic, and objective problem solving. They recognize that they have common interests, and they believe that they will all benefit from their joint effort.

Now, contrast that description with a competitive bargaining approach. In this mode each Party focuses on maximizing its own payoffs while conceding only enough to its opponent to obtain a basic agreement. Each Party views the other as an adversary, and the Parties debate their differences almost exclusively in terms of who will get how much of what. The only information that a Party shares is that which enhances its point of view, or increases its chances of winning. At the same time, each Party tries to learn all it can about the other Party's positions, needs, and minimum acceptable demands.

Clearly, these two strategies are essentially incompatible and impossible to carry out simultaneously. Collaboration is frequently viewed by managers and consultants alike as the more desirable approach. Its proponents argue that it leads to better long-run solutions, that it promotes authenticity in interpersonal and intergroup relationships, and that collaborative experiences lead to an improved organizational climate based on personal abilities, trust, and openness rather than political interests, competition, and job security.

Unfortunately, however, the realities of negotiation situations often prevent this ideal from being realized, or even approached. Collaboration does have great potential for improving organizational effectiveness, but Negotiators who approach every situation in a collaborative mode often find themselves being exploited by others who are more interested in winning than in the overall quality or fairness of the outcome.

On the other hand, Negotiators who always take a "tough guy" approach may win more often than they lose, but they may also be missing out on better or more profitable agreements. Furthermore, managers who regularly "win" interdepartmental negotiations often achieve solutions that are suboptimal from the total organization's perspective.

Thus, choosing a negotiating strategy that fits the requirements of the situation is an important managerial decision. Unfortunately, however, very few administrative situations are either purely "win/win" or purely "win/lose," so the selection and implementation of an effective negotiating strategy is usually not a simple process.

Choosing a Negotiating Strategy

Assessing a negotiation situation for the purpose of developing an appropriate strategy requires looking at three broad categories of situational factors: (A) the nature of the problems or issues being addressed; (B) the characteristics of each of the Parties and the relationships between them; and (C) the context in which the negotiations occur. A complete analysis requires looking not only at each of these elements, but at the interactions among them and at their evolution over time. We will begin, however, by considering each kind of factor independently, and identifying how these variables affect the choice of a collaborative or a competitive negotiating strategy.

The Problems or Issues Being Negotiated

By far the most significant situational variable that must be considered is the nature of the problems being negotiated. More precisely, the important question is the meaning that each problem has for each Party. Generally, a collaborative negotiating strategy will be more likely to succeed if each of the following questions can be answered affirmatively.

1. Are the problems themselves primarily technical or procedural, rather than distributive? This is the most fundamental question. If the issues that separate the Parties generally involve the allocation or distribution of a scarce resource, then the situation is more competitive than cooperative, and competitive bargaining is called for.

In contrast, collaborative problem solving works best when the issues are unresolved technical or procedural problems whose solutions will benefit all the interested Parties. Technical problems lend themselves to rational, analytic problem solving rather than political decision-making. Furthermore, technical problems often serve as a "common enemy" in that the need to resolve them brings together Parties who might otherwise be more concerned about their differing goals, or about maximizing their individual shares of the outcome.

However, assessing the nature of the problems at stake is usually considerably more complex than a simple judgment about the balance of common and conflicting issues. Since most negotiations involve more than one issue, even parties with vastly different goals or diametrically opposed interests often collaborate in the search for a "package" of agreements that both sides can live with. The common desire to find <u>some</u> agreement can become the driving force that keeps the Negotiators coming back to the table to explore each other's demands, priorities, and willingness to compromise. Thus, even when the issues themselves are basically zero-sum, the Parties share the problem of finding a workable agreement, and that process can be treated as a technical problem that calls for a collaborative effort.

2. Are the problems of roughly equal importance to the Parties? This is really a double question, in that both absolute and relative importance are of concern. If the stakes are much higher for one Party than the other, then their interest and motivation to find a common solution will probably not be equal. And without equal motivation, effective collaboration is very diff-cult. Collaborative problem-solving can be a tough, demanding, and time-consuming process, and if the Parties are unequally concerned about finding a common solution, then the process will very likely break down.

Each Party's subjective ranking of the issues is also an important consideration. Interestingly, when the Parties place very different preference rankings on the issues, then a distributive agreement is usually easier to reach. Suppose you are negotiating over drilling rights to an oil field with a cattle rancher who owns the property. You want the oil and the rancher wants to retain his grazing land, while both of you are interested in the profits you expect to get. Since your substantive interests are quite different, it should be relatively simple to devise an agreement that gives you access to the drilling location as long as you do not destroy the surrounding pasture. Compare that kind of negotiation with one in which the property where you want to build an oil storage tank is right in front of the rancher's new $150,000 home overlooking a scenic river valley. In this case, your interests are diametrically opposed, but your preference rankings are identical (both of you want control over the appearance of the same piece of property).

3. Are the problems complex and uncertain? Problems that are complex, that do not have obvious solutions, or that demand innovative problem-solving, usually require some collaboration even if there is ultimately a need to distribute the resulting benefits. Collaboration involves the different Parties combining their unique knowledge and perspectives to devise an improved solution. In a sense, the search for an acceptable package of agreements, mentioned earlier, is an example of a complex, uncertain problem that confronts all the negotiating Parties equally.

4. Are the major issues explicit and objective, rather than implicit and subjective? Collaborative problem solving is an analytic but exploratory process in which the participants focus on the substance of the problems. Collaborative solutions are generally developed and evaluated on their merits, rather than on the basis of who proposed them, or who will get credit for the solution. Yet every bargaining situation also involves intangible issues like status, self-esteem, and reputation. If these kinds of intangible factors are actually more important than the explicit, objective issues, then collaborative problem solving will be virtually impossible. Political interests, concern over winning rather than losing, and personal concerns about credibility can completely block attempts to resolve problems rationally and analytically.

While you cannot eliminate or ignore such subjective issues, the diagnostic question is how significant they are in a given situation. It is difficult to negotiate subjective or emotional issues, but they clearly affect the decision-making processes. If emotional issues predominate, then they must be recognized and dealt with before the Parties can move into a collaborative mode.

The Parties and Their Relationship

The second set of structural factors affecting your choice of negotiating strategy involves the individual and group characteristics of each of the principal Parties, and the nature and quality of the relationship between the actual Negotiators and the Parties they represent. And, since relationships exist and evolve at several different levels, assessment in this area is a particularly difficult and complex task.

The fact is that whenever two departments or two organizations (companies, government agencies, public interest groups, etc.) negotiate through designated Representatives (as they almost always do), there are at least three kinds of relationships involved. As Figure 1 demonstrates graphically, the Parties relate to each other at an institutional level, the Negotiators relate to each other at an individual level, and each Negotiator relates to his or her constituency as well. Furthermore, each of these three kinds of relationships can be assessed in both formal and informal terms. At a formal level, the relationships involve authority, power, and task-related dependence; at an informal level they involve status and prestige, politics, familiarity, trust, and perceptions of competence.

The following questions should help you think more specifically about who the Negotiators are and how they relate to each other and the Parties they represent. Generally, collaborative problem solving will be more likely to succeed in situations where these questions can be answered positively.

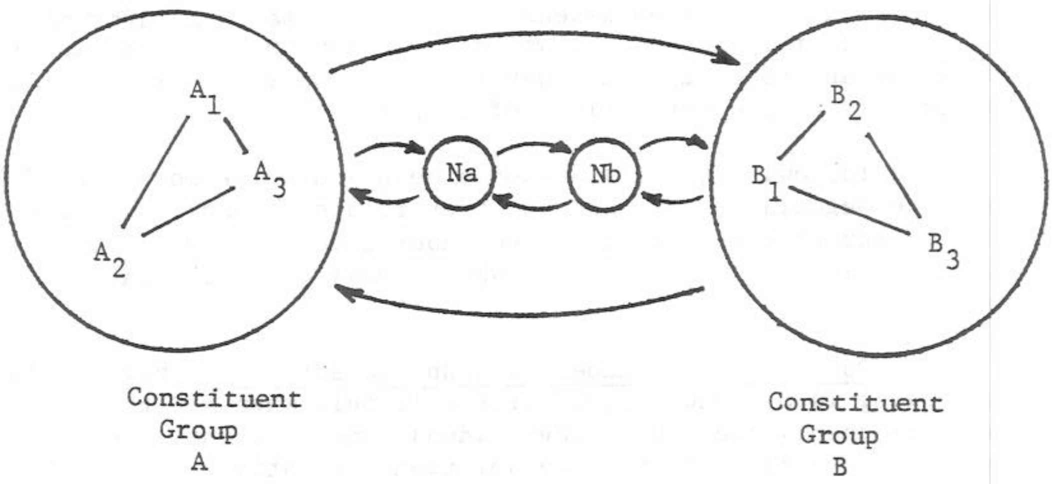
1. Do the Parties understand and accept each other? Collaborative problem-solving is a process that works well only when all the participants feel free to share openly their knowledge, ideas, and concerns. In a collaborative climate it is acceptable to propose solutions tentatively; to withdraw proposals after suggesting them; to share information about personal values, budget and equipment shortages, or management pressures, all of which may be constraining a Negotiator's flexibility or autonomy. In a competitive bargaining mode, by contrast, most of these tactics would be viewed as a sign of weakness and could curtail a Negotiator's bargaining effectiveness.

Thus, collaborative problem solving is facilitated by relationships between the Negotiators (and, ultimately, between the principal Parties they represent) that are open, trusting, and accepting of each other's goals, values, and particular constraints. Such relationships require a reasonable familiarity with the other Party or Parties, at both the institutional and interpersonal levels. Thus, a sales manager and a plant manager who know each other well, have worked together for years, and appreciate each other's job responsibilities would probably be far more collaborative than, say, a Controller and a Director of Research who have not previously met personally, who are negotiating a new project accountability measurement system, and who have vastly different views about the system's importance, its probable impact, and its design.

2. Do the Parties have equal or counterbalancing power? No matter how familiar they are with each other, the Negotiators are much less likely to establish a collaborative relationship if one of them is significantly more powerful than the other. A power imbalance makes both sides less interested in collaboration. The more powerful Party is generally less interested in expending the time and energy that an active problem solving mode requires, while the less powerful Party will find it much more difficult to initiate discussion of mutually beneficial ideas. Furthermore, the less powerful side is much more likely to feel defensive, threatened, and risk-aversive -- especially if it is highly dependent on the other Party for an important resource. Purchasing agents tend to treat sole suppliers with kid gloves, for example, and sales managers who cannot fill all their customer orders find it difficult to apply pressure to manufacturing managers whose plants are operating at full capacity.

Figure 1

Important Relationships in a Negotiating Situation



N_a = Negotiator for Group A

N_b = Negotiator for Group B

Adapted from J.S. Adams, "The Structure and Dynamics of Behavior in Organizational Boundary Roles" in Marvin D. Dunnette (ed.) Handbook of Industrial and Organizational Psychology, Chicago; Rand McNally, 1976.

Relative power is a complex subject with several different dimensions that were discussed earlier in the Organizational Behavior course. As you know, the underlying question is one of dependency: just how much does each Party need and want what the other has? However, in developing a bargaining strategy the most important question focuses on the amount of mutual dependency. If a rough balance exists, then there is a good opportunity to establish a collaborative climate, because the mutual need for each other acts to bind the Parties together in a common search for a mutually beneficial agreement.

In addition, it is well to remember that there are other sources of power in addition to control over tangible resources. Intangible power -- stemming from individual competence, credibility, or prestige -- can have just as important an impact on the negotiating climate. Higher status groups often take firmer bargaining stances simply because their prestige allows them to hold out longer for what they want. Thus, a complete assessment of relative power involves looking at both tangible and intangible sources, and predicting the impact the relative amounts are likely to have on the working climate during the negotiations.

3. Is there an adequate level of trust in the relationship? Collaboration requires an atmosphere in which the Parties can freely share ideas and concerns, and that kind of sharing simply will not occur unless each side is confident that its openness will not be exploited. Trust is an intangible, fragile commodity that develops over time. Trust grows as the Parties demonstrate to each other the accuracy and reliability of their statements, and as they gradually open up to each other. The risk-taking and experimentation inherent in collaborative problem solving requires a high level of trust. Thus, when the negotiating Parties do not know each other well, or interact only infrequently, they tend to be more formal and less flexible in their demands -- and thus more oriented towards competitive bargaining.

4. Will the relationship continue beyond the present negotiations? When the Parties know or expect that they will be interacting regularly in the future, they are much more likely to move towards a collaborative mode. This tendency is a natural result of their recognition that an overly "hard" stance in the present may well be costly in some future negotiation. When people know they will be interacting frequently or will be dependent on each other in the future, they are much more willing to work hard at establishing a personally satisfying and organizationally productive relationship. Furthermore, continuing relationships tend to be important ones with relatively high stakes.

5. Do the Negotiators have adequate authority and autonomy? One of the key ingredients of collaboration is flexibility. The Negotiators must be able to adjust their demands and even their decision criteria in response to each other's proposals. If one (or both) of the Negotiators is severly constrained by his or her department's policies or guidelines, then the negotiations are likely to be interrupted frequently by the need to clear new positions with appropriate managers back in their "home" departments. These kinds of interruptions are not only time consuming and frustrating, but they tend to increase the formality of the negotiations, and to decrease the level of trust and respect that the Negotiator commands. Each of these consequences tends to make collaboration much more difficult to achieve.

6. Do the Negotiators prefer collaboration, and have the skills to do it well? The personal values and bargaining skills that the Negotiators possess are also important factors affecting the choice of a preferred strategy. If you know that the Negotiators you will be dealing with are "hard" bargainers who prefer an adversary relationship and value "winning" above all else, then you should expect to be involved in competitive bargaining even if the issues and the basic nature of the relationship point towards collaboration. Don't lose sight of your own values and preferences, however. Even when you are confronted by a hard, competitive bargainer, it is possible, over time, to move towards a more collaborative climate. But don't expect to accomplish such a transition quickly, or even in the context of one round of negotiations. Moving from a competitive to a collaborative mode can be a long and delicate process, especially when the initiative comes primarily from one side.

The impact of communication skills on choice of bargaining strategy is a subtle one. Therefore, it is a good idea to consider whether the Negotiators in a particular situation are likely to be sensitive enough to respond to the kinds of implicit signals and shifts of meaning that are so important in creating negotiated solutions. Inexperienced or inept Negotiators are much more likely to miss or misinterpret subtle or nonverbal messages, and the consequences could be very severe. If the other Negotiators appear to be relatively insensitive or incompetent communicators, then a tougher, more competitive bargaining stance will be less risky.

Contextual Factors

Even if the nature of the issues and the relationship between the Parties both point to a collaborative strategy, that approach may still fail unless certain other conditions also prevail. The context in which the negotiations occur affects their quality in several different ways.

1. Do important Others expect the negotiations to be collaborative? Within a single organization, interdepartmental and interdivisional negotiations are profoundly affected by the corporate culture -- the sum total of the formal systems, the prevailing norms concerning conflict resolution, and the specific expectations of senior managers. While these three types of influence will probably not be completely consistent, nevertheless there is usually a relatively well-defined range of acceptable approaches to joint decision making. Normally, the Negotiators themselves internalize the cultural expectations so thoroughly that they do not even consider trying other approaches.

The same kinds of external pressures also influence bargaining between representatives of different companies or organizations, although in more subtle and indirect ways. Since there is no common hierarchy or other control mechanism, the two Parties usually have substantially more latitude to fashion agreements. On the other hand, there may be fewer shared, superordinate goals of the kind that encourage collaboration when both Parties are part of the same organization. However, wider social norms, industry traditions, and top management expectations can have just as great an impact on interorganizational situations. Furthermore, many formal interorganizational bargain-

ing situations are subject to explicit legal constraints that narrowly define acceptable procedures. Union/management bargaining, government contract negotiations, and telephone, utility, and insurance rate hearings are just a few concrete examples.

Actually, in any bargaining situation there are several kinds of audiences and at least two kinds of expectations to be taken into account. Some "outsiders" have a very direct interest in the negotiation outcomes even though they are not directly involved in the negotiations themselves. Consider, for example, subcontractors who stand to gain significant new business if a major manufacturer lands a government contract; or, think about the impact of financing a major urban redevelopment project on downtown employers. These "third parties" who are affected by negotiations may or may not have any influence over any of the active Negotiators. If they do, then their stake in the outcome and the pressures they can bring to bear on the Negotiators do become an important consideration.

Outside Parties can have expectations about either the outcomes themselves or about the strategies that the Negotiators will use. In either case, those expectations can be an important factor in your own assessment of an appropriate strategy. If the third Parties expect you to be aggressive and competitive, and their expectations are important to you (for whatever reason), then it will be more difficult to develop an effective collaborative strategy. Similarly, if you know that the other Negotiator has important external relationships, then you know that his or her strategy will be constrained by the pressures that those relationships create.

The existence of important external relationships does not in itself make either collaboration or competitive bargaining more desirable. What does matter is the specific nature of the third Party expectations and the impact they have either on you or on the other Party. One frequent response to outside pressures is to engage in public posturing -- making clear, definitive demands at the beginning of the negotiations and publicizing them widely. This behavior is usually intended -- consciously or unconsciously -- to prove to the outside world just how firm and committed the Negotiator is. Clearly, such public statements also have the effect of committing the Negotiator more firmly to his or her demands. In this sense, outside pressures can become destructive of a collaborative relationship.

The only way in which outside pressures can facilitate collaboration is when the pressures are directly concerned with the negotiating <u>processes</u>, and are supportive of collaboration. For example, consider a company president who directs two division general managers to keep negotiating until they come up with an internal pricing system that fully satisfies both of them. The pressure from the president will certainly encourage the two general managers to work together rather than at cross purposes.

2. <u>Are the time pressures and other resources consistent with a collaborative approach?</u> Deadlines can be anathema to creativity. And collaborative problem solving, when it is successful, is a highly creative activity. If an agreement must be reached quickly, for whatever reasons (contractual obligations, lost business opportunities, bidding deadlines, etc.), then collaboration may be simply impractical, even if it would make sense for other

reasons. It takes time for Negotiators to explore fully all alternatives, and to build sufficient understanding of each other's needs and objectives. On the other hand, time pressures often facilitate distributive agreements, in that the need to resolve the issues is so imperative the Negotiators make concessions to complete the agreement that they would never make under other circumstances.

The availability of other resources also affects the appropriateness of a collaborative strategy. Exploring newly discovered potential solutions sometimes requires extensive (and expensive) data collection. In other situations a collaborative solution may require both Parties to incur unexpected "investment" costs in order to reap future savings. Thus, collaboration will be more likely to succeed in situations where the important resources are not in short supply (of course, the availability of sufficient resources may also eliminate the need for distributive bargaining. If there are enough resources to satisfy everyone's needs, then there may not be any reason to negotiate at all).

3. Do the physical arrangements support a collaborative approach? The location of the negotiations can have a definite effect on the way the Negotiators relate to each other. Negotiators, like other managers, tend to feel more comfortable, and thus more confident, when they are working in their own "turf," or at least in familiar surroundings. A neutral site tends to reduce feelings of territoriality or superiority that often affect the balance of power between Negotiators.

The location of the negotiations also influences the choice of strategy insofar as it affects the confidentiality of the proceedings. If the site is open to observers, or is simply close to the offices of one Negotiator's constituent group, then collaboration may be more difficult to achieve. Collaborative problem solving, as noted earlier, usually involves tentative, exploratory testing of new alternatives. And public visibility can put a solid damper on anyone's willingness to express new ideas. Discussion may prove the ideas impractical or even detrimental to the proposer's own interests, and public knowledge of those findings could be embarrassing or costly. When the negotiations are conducted in one Party's office, the "home team" Negotiators are more directly subject to observation or close questioning by their constituents. They are thus more likely to feel pressured in one direction or another. Therefore, collaboration will generally be most effective when the negotiations are being conducted in relative privacy at a neutral site.

This analysis has identified three clusters of situational variables that can affect the success of a collaborative problem solving strategy. The nature of the issues being negotiated is probably the most fundamental factor. The telling question is the extent to which the Parties' goals are incompatible. If one Party gets everything it wants, will the other Party or Parties be unable to get what they want? If the answer to this question is yes, then the situation has at least some distributive or competitive characteristics. As we have seen, however, a number of other factors also affect the choice of a bargaining strategy. In fact, it is sometimes possible to redefine both goals and issues to eliminate the basic conflict. The potential for that kind of redefinition is what makes collaborative problem solving such a compelling approach in so many situations.

When you are faced with a joint decision-making problem, give some consideration to each of the variables we have discussed, and then use a profile like the one displayed in Figure 2 to assess the specific characteristics of the situation. Only rarely will you encounter a situation where all of the variables line up along either the cooperative or the competitive ends of the scales. Nevertheless, a comprehensive diagnosis will usually point towards one strategy or the other. Of course, many common negotiating situations do contain both cooperative and competitive elements. We will now consider more carefully the kinds of dilemmas that arise in such "mixed" bargaining situations -- those that call for both collaborative problem solving and distributive bargaining approaches.

Mixed Bargaining

Collaborative problem solving and competitive bargaining clearly have distinctively different purposes. Mixed bargaining is not a middle-ground strategy; rather it refers to an approach that combines both purposes, and thus involves engaging in both strategies.

Mixed bargaining is a particularly difficult process because of the inherent incompatibility of the goals, styles, and techniques that characterize the two major strategies. Just consider the differences in the climate and in the consequences for the Negotiators between collaboration and distributive bargaining, as summarized in Figure 3. As you know, it is almost impossible for individuals to switch back and forth between such vastly different ways of behaving and relating to each other.

Even more significantly, actions that a Negotiator takes to enhance collaboration may actually weaken his or her position when the negotiations move into a competitive mode. To take a simple example, consider a production scheduling problem that was negotiated between a plant manager and a sales manager. A collaborative problem solving discussion revealed that the plant had idle equipment during the third shift that could be used to expedite a critical order for a major customer. Once the sales manager knew about the excess capacity, he pressured the plant manager to use it much more often, giving sales more delivery flexibility but increasing plant scheduling problems and overtime costs, and reducing maintenance time on the equipment. From the corporation's point of view the added sales and customer satisfaction might have been worth the added labor cost. However, the plant manager's initial willingness to problem-solve in an emergency may have resulted in added manufacturing costs and reduced flexibility over the longer term.

Mixed bargaining actually presents Negotiators with several critical behavioral and tactical dilemmas.* Some of the most important dilemmas are:

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* These dilemmas are spelled out in more detail in R.E. Walton and R.B. McKersie, "Bargaining Dilemmas in Mixed Motive Decision Making," Behavioral Science, Vol. II, 1966.

Figure 2

Factors Affecting Choice of Negotiating Strategy

THE ISSUES	Collaborative Strategy		Distributive Strategy
Nature of Issues	Technical or Procedural	————	Resource Allocation or Exchange
Basic Importance of Issues to the Parties	Equal	————	Unequal
Priority Ranking of Issues:			
Technical	Equal	————	Different
Distributive	Different	————	Equal
Problem Complexity	High	————	Low
PARTIES AND RELATIONSHIPS			
Parties' Understanding and Acceptance of Each Other	High	————	Low
Balance of Power	Equal	————	Unequal
Level of Trust	High	————	Unequal
Extent of Relationship	Continuing	————	One Time
Negotiator Authority and Autonomy	High	————	Low
Values and Skills	Prefer Collaboration	————	Prefer Adversary Approach
CONTEXTUAL FACTORS			
Salience of Outsider Pressures	Depends on substantive nature of pressure		
Time and Other Resources	Ample	————	Scarce
Physical Arrangements	Neutral and Private	————	Public

Figure 3

Collaborative versus Competitive Bargaining

	Collaborative Strategy	Competitive Strategy
Basic Objective	Increase total gain	Increase own gain
Information Exchange	Maximum: candid sharing	Minimal: strategic disclosures
Purpose of Communication	Share problems; help each other; create new alternatives	Define demands; identify constraints, persuade
Openness to Change	Maximum: Solutions viewed as tentative	Minimum: firm commitment essential
Nature of Relationship	Informal; close; trusting; altruistic	Formal; distant; respectful; exploitive
Focus of Attention	Common problem	Winning and not losing

Flexibility v. commitment. Collaboration requires an open, exploratory, and tentative attitude towards the problem and possible solutions. In contrast, competitive bargaining is enhanced by taking a firm, committed position and demanding concessions from the other Party.

Information sharing v. withholding. Collaboration involves a joint search for new solutions that will increase the total payoff. Collaboration thus requires sharing ideas, proposals, and constraints in a spirit of mutual help. Competitive bargaining, on the other hand, requires withholding information that may be detrimental to one's own demands and deliberately ignoring information that would increase concern for the other Party's needs.

Discussing real needs v. giveaways. Problem solving calls for candor and focusing on genuine preferences, needs, and concerns. Success in competitive bargaining, in contrast, is often facilitated by enlarging the list of problems and demands well beyond "bottom line" objectives. These "giveaways" can then be conceded as a part of the "horse trading" that is expected in the final stages of distributive bargaining.

Giving Negotiators autonomy v. restricting them. When the Negotiators have extensive autonomy and authority to make commitments and concessions, then collaboration is much more feasible. The Negotiators can react to each other and to new proposals instantaneously, maintaining the underlying climate of mutual support and assistance. On the other hand, competitive bargaining often benefits from narrow constraints on a Negotiator's authority. The Negotiator's need to clear proposals with higher authorities can serve to delay commitments and buy time to assess the consequences of new alternatives. Furthermore, the fact that the Negotiator's hands are tied on certain issues serves as a useful way to avoid making concessions without completely disrupting the working relationship between the Negotiators.

Deadlines v. open-ended discussion. Collaboration takes time; it requires an exploratory, creative dialogue between the Negotiators. Deadlines inhibit creativity by reducing the time available to consider innovative suggestions. Deadlines serve a very useful purpose in competitive bargaining, however, in that they force the Negotiators to make difficult priority decisions, to concede on unimportant issues, and generally to push towards reaching agreement before time runs out.

These five dilemmas are by no means a comprehensive list. In fact, each of the situational variables discussed earlier poses a comparable dilemma. To the extent that the Negotiators can influence the conditions under which they interact, they are faced with a number of critical choices, and the choices they make will either enhance or reduce their effectiveness.

Tactical Suggestions

Negotiating successfully in mixed situations is largely a matter of carefully sorting out and sequencing the treatment of the issues that separate the Parties. The issues being discussed can be expanded, contracted, combined, separated, or linked up in a wide variety of ways. Experienced Negotiators

focus most of their attention on how the issues can best be "bundled" or "unbundled" to create a "package" of agreements that will be acceptable to all of the involved Parties. It is important to remember, however, that the order in which the issues are discussed is just as important as how they are linked up with each other. While it is difficult to define general principles for "bundling" issues, the following suggestions are all concerned in one way or another with how to create successful packages in mixed bargaining situations.

1. Separate collaborative and competitive bargaining in time and space. It is not always feasible to achieve a complete separation, but to the extent possible be very clear (both with yourself, and with the other Negotiators) about which mode you are engaging in. When you are explicit about your purposes, the differences in your behavior that accompany each strategy are much more acceptable.

There are many ways to achieve this kind of separation. Labor-management Negotiators often precede formal bargaining sessions with "fact-finding" discussions intended to clarify each side's basic assumptions, background information, and expectations. Such sessions frequently lead to innovative proposals that would probably never have evolved in formal, competitive bargaining sessions. Another separation technique is to use a formal agenda that very precisely defines the sequence of topics to be discussed. The use of subcommittees, meeting separately from the main negotiating teams, also facilitates separating different kinds of issues. A more subtle, but equally effective tactic is to use different meeting rooms, perhaps in very different locations, for each kind of discussion. Similarly, a quick recess followed by a private conversation in the hallway or another office, is a common technique for suddenly shifting the tone of a discussion. (Private meetings between principal Negotiators also permit more candid expressions of personal or organizational problems that cannot be expressed publicly. Such sharing serves to demonstrate trust and build personal relationships, though at the same time it increases a Negotiator's vulnerability.)

Another technique sometimes used by experienced negotiating teams is to have different people act as principal Negotiators during the different kinds of negotiations. Some individuals are more skilled at creating new solutions and achieving consensus, while others are more effective at presenting demands, holding firm, and persuading others to concede. The use of different people is another direct way of signalling a shift from one mode to another; and the new Negotiator is usually somewhat less confined by what has already been discussed or agreed to.

2. Sequence topics so that collaboration can precede distributive bargaining. Prenegotiation fact-finding sessions are a good example of this principle. Collaborative experiences, as just suggested, can build trust, understanding, and working familiarity between Negotiators that significantly improve the quality of later competitive bargaining sessions.

Be careful, however, not to sacrifice your own interests or imply agreement with the other side's position during these initial discussions.

If you do, you may discover that you have already conceded the major distributive issues. And, as already noted, if you share too much information in collaborative sessions, you may leave yourself with no fall-back positions when you get to competitive bargaining.

3. Alternatively, seek an agreement on percentage allocations first, and then move into collaborative problem solving. This approach is the exact opposite of the preceding one. It involves competitive bargaining first, primarily to avoid the vulnerability that sometimes results from early collaboration. When using this approach, the Negotiators first agree on a predetermined formula that defines how much of the eventual payoff each Party will receive. Then they work together to maximize the total payoff. For example, a company and a union might agree to split any productivity savings on a 50-50 basis, and then jointly brainstorm changes in work rules that will increase productivity without creating unemployment.

4. Create packages of issues that can generate "victories" for each Party. This tactic stresses the importance of finding ways for all Parties to benefit from an agreement, and to demonstrate to their constituencies or other audiences that they "won." Very often the first item on a formal negotiating agenda is to decide what issues are to be addressed, and those decisions in themselves usually provide ample opportunities for both collaboration and horse trading. In any negotiation that involves important competitive bargaining it is almost mandatory that there be enough issues on the agenda for each Party to find a combination of benefits and concessions that it can live with. Negotiators seriously interested in reaching a settlement can almost always find ways to allocate resources, exchange resources, or exchange concessions, if there are enough different issues on the table between them.

Summary

Developing a negotiating strategy that fits the unique characteristics of a specific situation is not a simple task. Because negotiating requires a subtle and complex blend of both cooperative and competitive approaches, it will probably always remain something of an art. Yet, like other artists, effective Negotiators develop their skills primarily through practice; they build a repertoire of analytical and interpersonal skills by paying careful attention to their successes and failures. The framework suggested here should help you think about negotiating situations in ways that will enhance your ability to learn from your own negotiating experiences. Negotiating is an art, but it is also a fundamental management tool.

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WHARTON REPROGRAPHICS

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TAIPAN'S MOVE

The decision of Sir Y. K. (Yuekong) Pao to take an equity position in Hongkong & Kowloon Wharf & Godown Co. (a property company) in 1978 was considered by most observers as a major departure in the investment policies he had articulated on many occasions. Until this step, Pao, a Chinese immigrant in 1949 from Ningbo near Shanghai, had concentrated his investments in ships, "assets that can be moved away from political trouble," based on the lesson he and his family learned vividly in 1949 upon their escape from the People's Republic of China.

Pao's initial major real estate acquisition in 1978 was 20 percent of one of the two property companies that were considered the domain of Jardine, Matheson and Company.

This investment was precipitated by the actions of another Hong Kong Chinese tycoon. In early 1978, Cheung Kong (Holdings) Ltd., controlled by Li Kashing, was seeking to acquire enough shareholdings in Hongkong & Kowloon Wharf & Godown Co. to enable Cheung Kong to gain substantial control of the company's valuable land assets. These lands were located primarily at Tsimshatsui on the tip of the rapidly developing Kowloon business district and waterfront. However Cheung Kong later abandoned the plan in favor of a takeover attempt of another company. Li Kashing sold his Hongkong & Kowloon Wharf & Godown stock to Sir Y. K. Pao at what was reported as a "substantial profit."[1]

By mid 1980, Pao's ownership of Hongkong & Kowloon Wharf had increased to 30 percent, compared to the 20 percent ownership held by Hongkong Land, in turn owned partially by Jardine. See the diagram in Exhibit 1 which summarizes the ownership and relationships on June 1, 1980 of the firms involved.

Jardine, Matheson and Company

"Jardine" was founded on the "China Coast" in 1832 by two Scotsmen, William Jardine and James Matheson. The partnership began as an

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[1] James Leung, "Jardine Moving to Protect its Interests in Major Hong Kong Property Companies," Asian Wall Street Journal, November 19, 1979.

This case was prepared by Professor D. Daryl Wyckoff as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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upstart competitor to the East India Trading Company, nicknamed the John Company, that was trading for Chinese goods. In 1841, Hong Kong was ceded to Britain by the Emperor of China as a concession in the Opium Wars. Jardine and Matheson then consolidated their partnership and operations in the new colony. Jardine's trade was in Chinese goods, referred to by the Old China Hands at the time as "muck and truck." This included tea and opium (described by Jardine as "the softest and most gentleman-like speculation I am aware of"). The business prospered during the "glory days" of China trade, particularly after the East India Trading Company's "official" monopoly franchise over trade in the Far East was eliminated in 1834.[2] The Jardine and Matheson hong (large trading house) of this period served as the model for James Clavell's recent book Taipan, a popularized historical novel about Hong Kong of the period.

William Jardine and James Matheson returned to Britain with sufficient earnings to retire from trade and to enter new lives in 1841 and 1842. Ownership and management of the hong eventually passed to the Keswick family, related to James Matheson by marriage. From 1843 the taipan (top manager) of Jardine was a Jardine or Keswick descendant.

Jardine was one of the few European hongs to survive into the modern era of Hong Kong. All other except for two, Hutchison Whampoa Ltd. and Butterfield and Swire Ltd. (considered by some as an upstart because it began rather late as a shipping rather than a trading company in 1866), collapsed in a series of bankruptcies in the late nineteenth century when China trade failed to materialize to meet the high expectations of the European and American investors who had rushed to the Orient for riches.

Described as "an old fashioned Scottish firm," Jardine quietly continued to build its trade in China from its secure Hong Kong base. One Scot after another came to the colony to join the "princely hong" to make his fortune and return to retire in the U.K. While the hong may have been described as quiet and old fashioned, its power was certainly felt in Hong Kong. A popular saying was that Hong Kong was ruled by Jardine Matheson, the stewards of The Royal Hongkong Jockey Club, the Hongkong & Shanghai Bank, and the governor, in that order of descending importance.

The Jardine hong was agile and continued to trade on the China coast no matter what political upheavals occurred. This included maintaining operations in Shanghai and Hong Kong during the Japanese occupation in World War II.

Jardine, Matheson & Company was listed as a publicly traded company on the Hong Kong Stock Exchange in 1961. This was the first time

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[2] Colin Criswell, The Taipans, Hong Kong: Oxford University Press, 1981, p. 33.

that the hong's financial position was a matter of public record. Also, this influx of capital allowed Jardine to undertake investments in a variety of companies.

After Jardine had to withdraw its operations from Shanghai in 1949, its profits were even more dependent on the continued prosperity of Hong Kong. Threats of a "doomsday" for Hong Kong in 1997, when the lease from China on major portions of the colony would possibly lapse, and a desire to participate in new markets led Henry Keswick at age 32 in 1970 to look abroad for new investments when he became taipan. The hong, as a trading company, traded in "everything from Dunhill lighters to power plants, tubes of Christian Dior lipstick to the new Hong Kong subway."[3]

Under Keswick's leadership, Jardine acquired Theo. H. Davis and Company, a Hawaii-based sugar producer, in 1973. Reunion Properties, a British property company, was bought to capitalize on the London real estate boom. By 1975 investments had been made in South Africa, Saudi Arabia, and Australia. Simultaneously the trading company moved into insurance, money management, and merchant banking. Sale of Jardine shares during this period reduced the holdings of the Keswick family to about 15 percent of the company, the lowest it had ever been.

Unfortunately, the Hong Kong stock market collapsed in 1974 just as several of the hong's acquisitions failed to perform as expected. For example, sugar prices dropped from 60 cents per pound to 8 cents and the London properties market began to slide. In 1975, Henry Keswick left Hong Kong, and David Newbigging, the next heir in line, took control of the company and sought to bring order and rationalize the portfolio of Jardine acquisitions.

From 1975 to 1978 Jardine's profits grew by 50 percent. Then, in 1979, earnings increased 20 percent in one year. This came about as the result of the liquidation of the low-yielding investments of the early 1970s, including Reunion Properties and Taft Brothers, an Australian sugar harvesting company. A jump in sugar prices to 40 cents a pound further helped the earnings. The Newbigging administration in 1980 appeared to be bringing a new prosperity to the hong. It was forecast that 1980 profits would make another 20 percent jump.

In early 1980 Li Kashing and his very profitable Cheung Kong (Holdings) Ltd. property company gained control of Hutchison Whampoa Ltd. This appeared to take pressure off Jardine from future attacks on Hongkong & Kowloon Wharf from Li.

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[3]"Jardine's Battle with Hong Kong's New Businessmen," New York Times, November 25, 1980.

Jardine in 1980 held equity in Hongkong Land Co., which in turn held shares in Hongkong & Kowloon Wharf. (See Exhibit 1.) The Jardine chairman was traditionally the chairman of both properties companies. The values of the properties companies were difficult to evaluate in the face of the booming Hong Kong real estate market. For example, the market value of Hongkong & Kowloon Wharf, based on the trading price of the shares, substantially underestimated the current market value of the assets of the company in the booming Hong Kong real estate market. Perhaps this difference was what attracted Sir Y. K. Pao's atypical investment when the Hongkong & Kowloon Wharf stock was offered to him by Li Kashing. To understand why this was such an unusual investment for him, it is necessary to review the background of Sir Y. K. Pao.

Sir Y. K. Pao

Pao Yuekong was born in 1919 in Ningbo, a seaport near Shanghai, China. The son of a successful merchant, Pao's college education was interrupted by World War II. His initial attempt at banking was frustrated by the Japanese invasion of Heng Yang. After the war, he became the chief executive of Shanghai's Municipal Bank, but escaped to Hong Kong in 1949 just as the Communist forces entered Shanghai. He and his family abandoned their properties in China, but arrived in Hong Kong with sufficient funds for his father, S. L. Pao, and several other relatives to establish themselves as merchants, mostly handling trade with the People's Republic of China, the regime they had just escaped. The China trade was not particularly rewarding, and the Paos began looking for new businesses. S. L. Pao favored real estate, while other family members suggested textiles as other Shanghainese had entered. Y. K. Pao felt that there was a lesson to be learned from the holdings the family had forfeited in China. He was looking for "movable assets," and shipping seemed to be the answer to him. He invested US$770,000 in the small coal-burning ship Golden Alpha, the beginning of his fleet. He used the profits of this ship's charter to a Japanese shipping firm to finance other ships. By the end of 1950 he had seven ships.

Ship owners had traditionally attempted to capitalize on upswings in demand to capture high income on single-voyage "spot charters." However, this practice also had the problem of what to do in periods of little or no business.

Y. K. Pao, perhaps demonstrating his banker's conservativism, turned to "bare-boat" and "time" charters. "Bare-boat charters" might be thought of as medium- (5-8 years) or long-term leases (perhaps 8-12 years) which offered an assured, but nominal income to the owner. The owner essentially provided the ship, but the customer provided the crew, fuel maintenance, and all other operating expenses during the term of the charter. Under a time charter, the owner took on more responsibilities for the term of the charter, usually providing the crew and maintenance.

A key to Pao's success in the 1950s was the way he managed risk and packaged it for bankers for investment. While most banks were uninterested in ship financing, considering it too risky, Pao's approach addressed this. For example, Pao, needing about US $750,000 to finance the purchase of a US $1 million ship in 1956, created a new form of "risk-free" financing. His charter customer, Nitto Shipping of Japan, at Pao's request, went to the Bank of Kobe and secured a letter of credit (and ship) for the required US $750,000 which equaled the first year's charter fees. Pao went to the Hong Kong Shanghai Bank and put up the letter of credit as collateral, where the ship itself would not have been accepted as collateral. Everybody was happy: Nitto had a charter of a ship at rates below the spot market and not flying a Japanese flag, thus was not required to operate with expensive Japanese crews and other rules; Pao had his ship; the Hong Kong & Shanghai Bank had financed a letter of credit of a respected Japanese bank, in addition to a ship as collateral. Pao was financing letters of credit rather than ships only, and he could continue to do this as long as he was willing to forego high short-term profits from the spot market.

A further refinement of Pao's financing innovation stemmed from his close relationships with the Japanese shipyards and shiplines. The Export-Import Bank of Japan offered favorable rates on loans to foreign companies to buy Japanese built equipment. These loans were not available to the Japanese ship lines; however, Pao could borrow these funds to build ships in Japan and charter them on very thin margins to the Japanese lines on very safe bare-boat or time charters with Hong Kong or Korean crews. Pao was also willing to have some of the hire paid in Japanese yen.

By the time of the 1973 world oil crisis, which led to an oversupply of ships, Pao had constructed an impressive group of companies. In the processes, the Hongkong & Shanghai Bank had become a significant equity investor in Pao's enterprises. At that point, it was estimated that the bank, of which Pao had become a director in 1971, had book values of over US $50 million in the firms that constituted World Wide Shipping as follows:

Company	Hongkong & Shanghai Bank Interest
World Maritime Bahamas Ltd.	40%
World Shipping Investment	45
World Leasing Ltd.	37½
Eastern Asia Navigation Co.	10

Eastern Asia Navigation Co. was publicly traded with approximately 20 percent of the ownership held by investors outside Pao and his family and the Hongkong & Shanghai Bank.

It was estimated by <u>Fortune</u> that the book value of Pao's holdings in the World Wide Shipping Group were over US $100 million, but applying the market prices of Eastern Asia's stock prices in 1972, the holdings

were estimated to be more like US $700 to US $800 million.[4] This represented a fleet of 70 dry-cargo ships and tankers totaling about 4.8 million deadweight tons. This put him just slightly behind the American shipowner Ludwig and Greek shipowner Onassis, each owning about 5 million deadweight tons.

Pao seemed to be doing well in 1973, but some observers predicted problems for him as the demand for tankers slackened in the mid 1970s. In fact, most shipowners were crippled when tankers were laid up out of service as the spot market collapsed. However, this is when the wisdom of Pao's conservative assured income approach was proven. His Japanese customers honored their commitments, and his low-cost operations meant that his ships continued to be operated when others were put off charter.

By 1980, Pao controlled a 200-ship fleet of 20 million deadweight tons of capacity operating under the World Wide Shipping banner, which included Pao's personal companies, as well as Eastern Asia Navigation Co. and the recently created World Investment, both partly owned by the public.

Sir Y. K. (knighted by Queen Elizabeth II in 1978) was described once as "a man of boundless drive and energy, at least partly motivated by what the Chinese call hao sheng, meaning roughly, 'love of preeminence.'"[5] Fortune went on to describe Pao as a "nervous wreck set to Chinese music." However, Pao carefully controlled his life. He followed a routine of rising at 6:00 a.m. for daily calisthenics and swimming. He usually worked at least 12 hours at the office followed by overseas calls from his home in the evening. He traveled a great deal, spending about half his time in Japan, Britain, and the United States, and forced himself onto local time seeming to ignore jet lag and time zone adjustments. He did not smoke, and did not like those around him to, and he drank wine only to the extent that he felt it was socially necessary. While seen at many social events, he was likely to stay only long enough to have made an "appearance."

His personal style was moderate, and he deplored excess, except in work. Many Japanese firms had highly developed ways of entertaining foreign customers or partners, often involving relays of Japanese managers escorting the visitor through evenings of lavish meals, drinking, and merriment which "oiled" negotiations. Pao would quietly opt for golf, also a passion of Japanese executives. At times, Pao seemed more Japanese than his Japanese counterparts. He worked easily with the Japanese or Communist Chinese government, and never showed any evidence of grudges from abuse he and his family had experienced. Like many Overseas Chinese businessmen, his interests appeared to be commercial rather than political. However, he did not do business with the Republic of China on Taiwan.

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[4]"The Chinese Landlubber Who Came to Rule the Seas," Carol J. Loomis, Fortune, February 1973, pages 94, 116, and 120.

[5]Ibid., p. 90+.

He was described as "busy making a living."

Sir Y. K. Pao was devoted to self-education. When he decided that shipping was to be his business arena, he undertook an exhaustive program of self-education, visiting shipyards and shipping companies, and reading and studying everything he could find about the subject, including engineering, economics, and politics. He expected members of his firm to do the same believing that "continuous learning is everyone's responsibility." Describing his sons-in-law who had joined him, he gave them his highest compliment, "they work very hard."

Pao was detail oriented. All charters for ships were passed to him for detailed review. He placed all orders for new building of ships, and of course he handled finances. In his office he had an elaborate chart which recorded the daily position of every ship in his fleet. At the other end of the office was a board (usually empty) listing ships off charter. All candidates for employment in staff and management positions were interviewed personally by Pao. He would often check their references himself. All of the officers of his companies were family or long-time employees (or their sons), often known by Pao from his Ningbo and Shanghai days. In commenting on his management style, Pao stressed that the key to his approach was "trust." An individual earned Pao's trust after years of a relationship, and trust could be destroyed in one instant or by one action. Two topics regularly recurred in Pao's conversations. The first was trust and relationships (with customers, lendors, suppliers, employees, and partners). The second was deadweight tons of shipping capacity - his and others'.

Sir Y. K. Pao was a cosmopolitan figure and active in the international financial, business, and shipping communities. He was often seen at shipping meetings in Europe and the United States, and was an advisor to several U.S. banks. His four daughters and sons-in-law lived in New York, London, and Hong Kong. But he was also an active figure in Hong Kong.

Pao was still well connected in China, and he recently had created a joint venture shipping company with the People's Republic of China, perhaps one of the few ventures China had invested in for "overseas profits." Although he spoke English for most business transactions, he spoke several dialects of Chinese. When he was working on a confidential deal, or he was mad, he was known to speak only in the rare Ningbo dialect with his closest confidants.

He identified himself with Hong Kong, and he was a major financial supporter of community programs. Pao served on the boards of several Hong Kong companies, and he regularly joined the taipan at lunch in the private penthouse dining room at the Jardine offices in the Connaught Centre overlooking Hong Kong harbor.

Hongkong & Kowloon Wharf and Godown Company

Jardine had increased its ownership position in Hongkong Land Company to about 32 percent through stock exchanges in 1979 when there had been rumors that Li Kashing and Cheung Kong (Holdings) Ltd. might attempt a takeover of that firm. This exchange also resulted in Hongkong Land now holding approximately 10 percent ownership of Jardine's equity.

It was believed that the true value of Jardine's ownership of 20 percent of Hongkong & Kowloon Wharf through Hongkong Land was greatly understated by the market values of the stock. The value one might place on the stock depended on whether the company were to be liquidated as properties or operated.

Hongkong and Kowloon Wharf derived a substantial portion of its income (36 percent) from earnings from office space rentals in Tsimshatsui in Kowloon and residential properties in the high-rent areas of Hong Kong Island. Earnings from operating several docks and cargo ports represented nearly 13 percent and hotel rentals were 19 percent. The transportation operations were 11 percent.[6] So, profits from investments were roughly 21 percent. One could only guess at the true value of this investment. Perhaps the recent market price was a fair indication. But others estimated that a value closer to HK $100[7] was more likely correct. The stock price had been drifting up, as seen below.

Date	Price HK $
April 12	63.00
June 2	65.00
June 16	68.50
June 19	73.50
June 20	77.00

The only other major holding of Hongkong & Kowloon Wharf outside of Hongkong Land's was that of Sir Y. K. Pao. The remaining ownership was fragmented among numerous small holders. At 30 percent ownership, Pao's continued purchase of the "undervalued" shares from the public already threatened to give him unquestioned control of Hongkong & Kowloon Wharf.

How could Pao's advance on Hongkong & Kowloon Wharf be stopped? Or should it be?

Jardine had realized considerable cash as the result of recently increased profits from operations as well as the sale of other holdings. This cash could be used to bolster less successful Jardine operations or buy in Jardine stock from the public. However, another use of the cash would be to quietly compete with Pao buying up the

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[6] Vigor Fung, "Kowloon Wharf's Net Up 36%, Due to 1979 Property Boom," Asian Wall Street Journal, April 12, 1980.

[7] HK $1 was equal to approximately US $.20.

publicly held shares of Hongkong & Kowloon Wharf. Pao was bound to realize this was happening, and the prices for the shares would certainly continue to move upwards. This might result in Pao taking unquestioned control anyway, and Jardine would have wasted its cash. However, no matter who finally held control, the market value of Jardine's current holdings through Hongkong Land probably would be closer to the true values of the company and might effectively give Jardine the opportunity to sell out Hongkong & Kowloon Wharf, but with some loss of face.

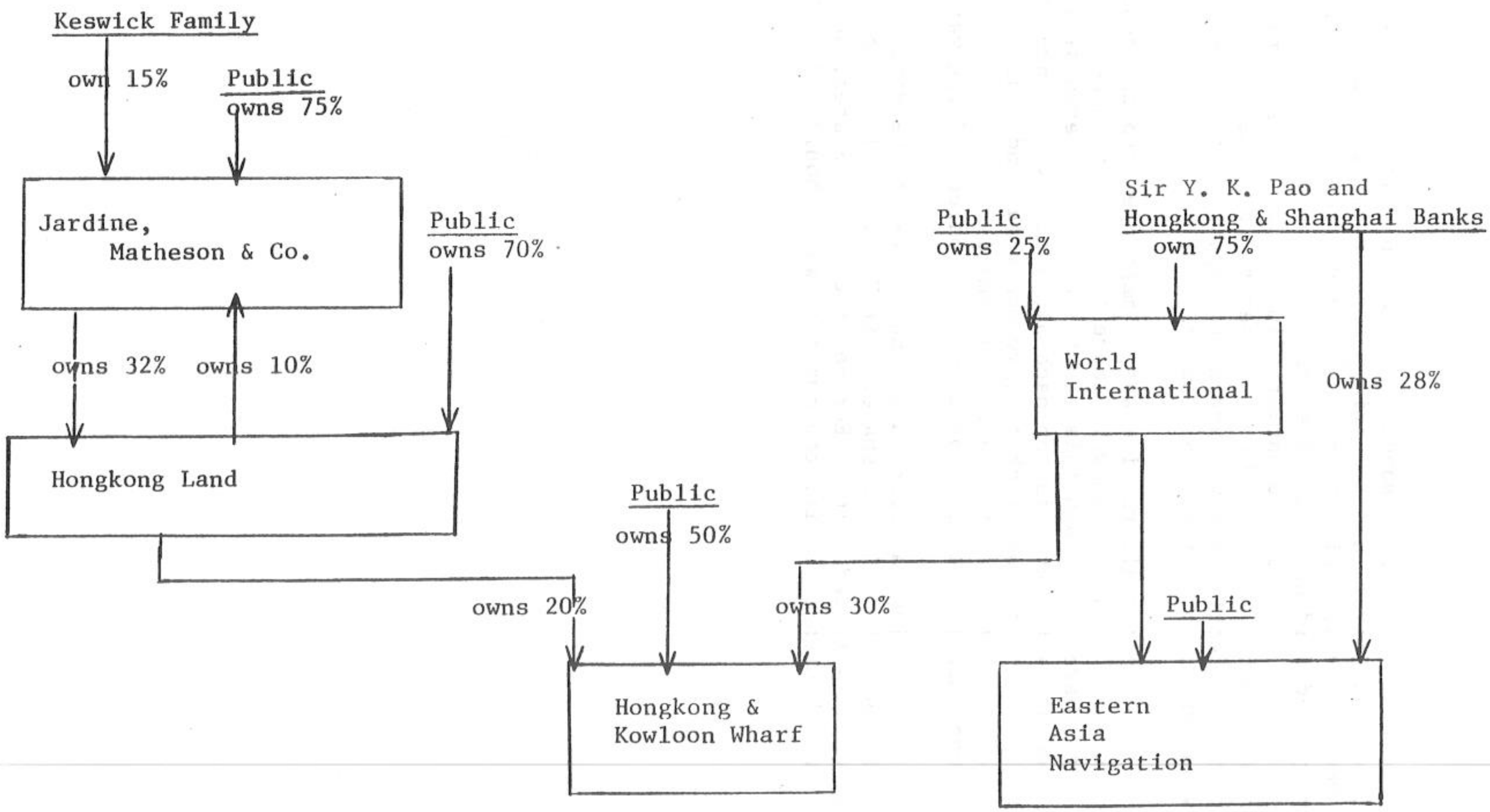
Another alternative was to make one surprise tender to buy the public stock at a premium well above the present market level and catch Pao off guard. Although this might seem like an expensive move, Jardine management felt that this approach had a fairly high probability of securing the 29 percent of the stock to give Hongkong Land undisputed controlling interest, and the premium paid to accomplish this would probably be less than what might have to be paid in a prolonged bidding war with Pao.

Jardine had readied a tender offer to be made by Hongkong Land for shares at HK $100 per share. Sir Y. K. Pao left the colony in early June on an extended trip to Europe, the United States, and Mexico. Taipan had enough cash to do it, the question was, should he?

Exhibit 1

TAIPAN'S MOVE

Ownership of Related Hong Kong Companies, June 1, 1980



Note: The levels of ownership shown above are based on estimates reported in the press and could not be confirmed.

13 WHARTON REPROGRAPHICS

Restructuring in Transit To a New Era

Business and deal-doing are moving from the decade of hidden assets to the decade of hidden liabilities.

by Barbara Moakler Byrne and Robert Willens

Barbara Moakler Byrne

Robert Willens

The 1980s witnessed a wave of corporate restructurings that substantially changed the structure and dynamics of Corporate America. The restructurings were primarily efforts to increase shareholder value by one of two methods: maximizing asset value or creating more effective or efficient capital structures. Such restructuring assumed new importance in the '80s — which we like to call "the decade of hidden assets" — for many reasons:

- The growing importance of institutional investors, who focused on shareholder value as a measure of security performance and who were willing to accept a greater degree of financial risk through leverage.
- The recognition of hidden asset values, which were carried at historical book value after the inflationary period of the 1970s and which were not adequately reflected in equity market values.
- The renewed focus on core businesses.
- The emergence of a substantial, and until recently liquid junk bond market.
- Low nominal interest rates, coupled with a generally strong equity market.
- The emergence of the financial buyer.
- Changes in tax law that accelerated depreciation (which in turn increased emphasis on cash flow), equalized treatment of income and capital gains, and raised corporate tax rates above individual tax rates.

Clearly, the restructuring of the '80s addressed the financial and structural factors that caused corporate undervaluation. The financial factors were essentially excess cash and underutilized debt capacity. Obviously, how one characterizes "underutilized" is changing. The conventional wisdom of the '80s was that replacing equity with debt increases value. Today's conventional wisdom, which is really a return to the original conventional wisdom, is that there is a risk-reward ratio; or, put another way, some companies should not be leveraged. Each decade tends to reverse the excesses of the previous one.

The structural factors that made restructuring attractive were essentially underperforming subsidiaries, overhead bonus, and corporate buyer synergies. Underperforming subsidiaries pulled down the overall value of the parent. An overhead bonus is simply the fat in the organization. Corporate buyer syn-

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You will see with increasing frequency sales of minority positions, both for defensive and growth purposes.

ergies are the increased value found in linkage with a perfect partner.

Within the parent company, assets, operations, subsidiaries, divisions, or whatever might be undervalued because of:

Small size — a high-growth entity could have a high P/E ratio buried in a parent company where it can't really be seen.

Hidden strengths — these generate little income but have substantial value, typically real estate or off-balance-sheet assets.

Inappropriate valuation — usually companies with disparate operations, some of which would be valued on a price-earnings ratio, others on a cash flow basis.

Inappropriate ownership structure — a situation in which a subsidiary might better be owned in a partnership as opposed to a corporate structure, such as a master limited partnership in the case of real estate or natural resource assets.

Inappropriate management incentives — the inability to create value in a very entrepreneurial subsidiary, which can be set up away from the parent company and properly incented by entrepreneurial compensation schemes.

Potential synergies — subsidiaries whose operations might benefit from being associated with another entity with better operating, financial, or tax synergies.

Highly customized tools

These factors are very basic, and intentionally so. The tuning fork illustrated in the accompanying exhibit (see page 23) can provide a framework for understanding the various restructuring tools. Asset restructuring and financial restructuring are not mutually exclusive. The tools can be combined, and usually are. We've arranged them along the "Y" from what we think is the least radical to the most radical.

The tools can be highly customized to meet the business objectives and characteristics of an individual company. And they are customized for tax and accounting purposes. We can't emphasize this enough. Tax and accounting issues frequently drive the rather peculiar and arcane structures one reads about in the press.

Let's look first at asset restructuring options. Clearly, fundamental decisions have to be made here. Are you going to unbundle assets? Should you retain an interest in them? How should you actually divest them?

If a parent decides to retain an interest in a subsidiary, there are several options. One is a **joint venture**, which we think is going to become increasingly popular in next year or two. Generally, in a joint venture the subsidiary can be used as currency to deconsolidate itself or to create a strategic alliance to tap into new markets, technology, or distribution channels. A good example of a joint venture is the one involving Philips NV and Whirlpool Corp., whereby Whirlpool was able to tap into the European market through established distribution channels.

A company can also sell a minority interest in a subsidiary to a corporate buyer, which is not all that uncommon. It can be done very effectively with a foreign partner. Generally speaking, the company sells less than a 20% interest to maintain tax consolidation.

The **spin-off** options include an initial public offering (IPO), a master limited partnership, (MLP), and a shareholder distribution. An **IPO** is very flexible if there is a good equity market. There are a variety of different structures — primary and secondary offerings, or a leveraging-up of the company so the parent can take a pre-offering dividend. Typically, in an IPO some 13% to 18% of the stock is sold so the parent can continue to tax consolidate. The IPO has been used as an alternative to a third-party sale.

The **MLP** is now fairly limited to real estate and natural resource assets. There are ways you can pull in additional assets, but they must be principally natural resources. An MLP allows you to value a company as a multiple of distributable cash flow, as opposed to net income. It avoids the corporate layer of tax and it gets the asset off the balance sheet of the parent company. Yet the parent can continue to control it. An example is the Plum Creek MLP, a spin-off by Burlington Resources Inc. of its timber operations.

There have been a number of **shareholder distributions**, and we think we're going to see quite a few more. Shareholder distribution actually is the technical definition of a spin-off. They are usually structured to qualify as a tax-free distribution. Of all of the spin-offs done since 1975, approximately 95% have been tax-free. There are three

types: a spin-off, a split-off, and a split-up. In order to be tax-free, five criteria must be met:

— You have to own at least 80% of the subsidiary that you want to spin off;

— You have to spin off at least 80% of it;

— You must have a valid business reason for wanting to spin off the subsidiary;

— It has to have been a controlled subsidiary for five years and engaged in an active business for five years, and the parent has to be an active business as well; and

— The spin-off cannot be considered to have been a device to distribute capital gains income as opposed to ordinary income.

The reason we think there may be more spin-offs and split-offs is because they are really the only way to do a tax-free reorganization since the repeal of *General Utilities.*

Let's turn now to the unbundling options in which the parent divests itself of all interest in the subsidiary.

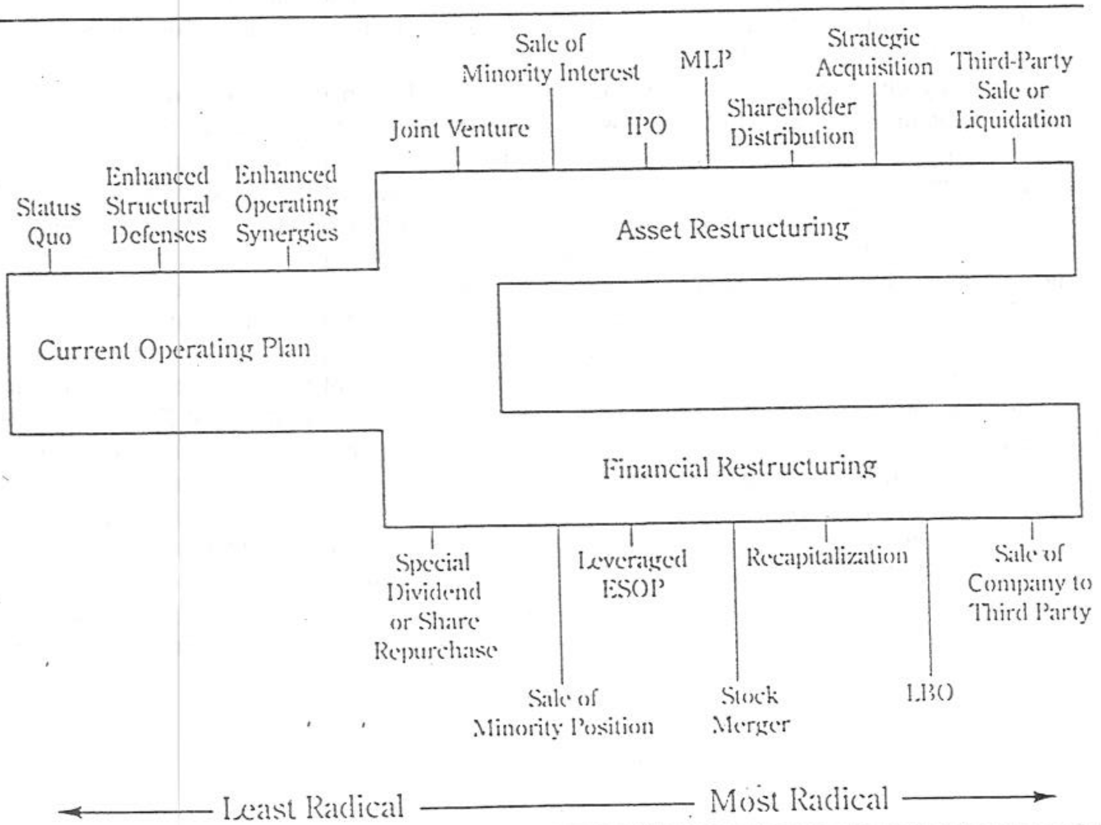
In an IPO you can sell the whole subsidiary in a public offering if you choose. In a very good equity market it can yield the greatest value, provide management with incentives, and position the company competitively in the market. Aristech Chemical Corp. is an excellent example. USX Corp. sold it to the public in a 100% IPO.

A shareholder distribution also can be used to spin off 100% of a company to the parent company's shareholders, or a shareholder distribution of a subsidiary can be used as a consideration in a stock swap. An example of the latter is the Mobil-Esmark-Vickers transaction. Mobil wanted to acquire Vickers, an Esmark subsidiary. Mobil bought a block of Esmark stock in the public market and swapped it for the Vickers subsidiary stock. This type of transaction has had some limitations imposed on it. However, a tax-free split-off is a way of accomplishing a tax-free share exchange by using subsidiary stock to repurchase parent company stock.

An MLP also can be used to sell 100% of a company. Or a company can be divested through a **third-party sale.** When there are synergies, this is the option that generally creates the greatest value.

Foregone capital expenditures are going to come home to roost for many companies.

Restructuring Options



Besides all the unbundling options just discussed, you can look at restructuring through **strategic acquisitions**, which is the flip side of restructuring that most people don't think of. Obviously, you could reposition your company that way. **Liquidation** of the entire company is another option. It's usually the least tax-efficient way of trying to do something, but for the sake of completeness we include it.

The vulnerability factor

Now to financial restructuring options. The key questions here, of course, have to do with your vulnerability to a takeover. To the extent that you feel that you are on somebody's screen, you almost definitely will want to take steps to concentrate and solidify insider control of ownership. And these financial restructuring options (see exhibit on previous page) lend themselves to accomplishing that objective. Obviously, the particular technique or techniques you select depend to a great extent on whether management has decided to grow through acquisition, or alternatively, to consolidate what has been built already and accept a smaller level of growth with a more rational business profile.

Obviously, there is a degree of prudence involved here. To the extent that you undertake a financial restructuring, you will be increasing your financial risk through increased leverage. In certain industries, and at certain points in the business cycle, that may not make a lot of sense. For example, in the commodity chemical industry, Quantum Chemical is being adversely affected by what might, in retrospect, be viewed as a very substantial $50 special dividend which the company paid in late 1988. Quantum discovered it wasn't able to maintain its regular dividend while continuing its planned capital expenditures. The company suspended its dividend because of covenant violations on its debt, a move which disappointed the market to a great degree. You really need to understand the business you're in, and you have to anticipate whether high levels of debt can be serviced when the business cycle troughs.

In a very good equity market, an IPO of a subsidiary can yield the greatest value.

With those generalities as a back drop, let's get back to the tuning fork and begin looking at financial restructuring techniques, starting with the least radical and working our way up.

Special dividend or share repurchase. Special dividends are relatively flexible and obviously quite popular. They're nonrecurring, one-time events as opposed to a dividend increase, which investors expect will be permanent. A share repurchase can increase earnings per share in cases in which the earnings yield — the inverse of the price-earnings ratio — exceeds the net aftertax returns to be earned on the redemption proceeds.

From a tax point of view, a special dividend is generally taxed as ordinary income to the extent of the company's current and accumulated earnings and profits, which is a tax term that is pretty much the equivalent of cash flow. To the extent that the distribution exceeds the earnings and profits, it's a return of capital; and to the extent that it exceeds your basis in the stock, it's a capital gain.

A cottage industry

A share repurchase, on the other hand, is simpler. It's taxed almost always as a capital gain to the extent that the buyback proceeds exceed the shareholder's basis in the stock. Obviously, with the elimination of the capital gains differential, the tax consequences at the shareholder level are a little less important than they were in the past. However, if a capital gains break is restored in any new tax legislation, that would tip the scales in favor of a share repurchase, all other things being equal.

Sale of minority position. This is an interesting technique that has become a bit of a cottage industry. Warren Buffett is good at buying minority positions at what to him are attractive prices. This is typically a defensive strategy known sometimes as a white-squire or blocking position. We're going to be seeing this more as a growth strategy. Company X will take a minority position in Company Y for the purpose of eventually exchanging the Y stock for a Y subsidiary that X would like to own for strategic reasons. This is more or less the Mobil-Esmark-Vickers deal. The tax law has changed since then. One can no longer do that kind of transaction back-to-back. In Mobil-Esmark-Vickers, the stock was acquired in the morning and surrendered after lunch for the desired subsidiary. This kind of transaction has to be done today

as a tax-free split-off. The shareholder must be established as a historic shareholder, which means owning the stock with more permanence than was the case in Mobil-Esmark-Vickers. Nevertheless, you will see this minority sale strategy with increasing frequency, both for defensive and growth purposes.

Leveraged ESOPs. All of us have read, probably more than we want to, about leveraged ESOPs. The most recent tax bill dealt with two familiar benefits — the tax-advantaged loan and the dividends-paid deduction. The tax-advantaged loan is essentially a thing of the past except where the ESOP owns more than 50% of the stock of the company, a situation we're not going to see very often. On the other hand, the more important benefit, the dividends-paid deduction — the ability of the company to deduct dividends paid on stock held by the ESOP — pretty much survived intact. And in response to that survival, Chevron Corp. announced — literally the day after the bill passed — a billion-dollar ESOP for tax reasons and probably for the traditional defensive purposes. The ability to deduct dividends is a powerful incentive to create a leveraged ESOP. They are going to be with us for a while.

Powerful form of currency

Stock mergers. These are what in the tax world are called tax-free reorganizations. These are invariably strategic transactions done typically by companies whose stock is relatively fully valued. It is a powerful form of acquisition currency. Taxes are not due at any level on the exchange itself. There can also be accounting benefits if the transaction qualifies as a pooling of interests under APB 16. This is very difficult to do — almost impossible, as a matter of fact — although the Bristol-Myers-Squibb transaction qualified as a pooling. A new basis of accounting for the assets cannot be established for the transaction to qualify. The assets are carried over at their historic value. Most importantly, goodwill is not created on the surviving company's books. There is no periodic amortization of that intangible asset against earnings. So, this is a powerful incentive for companies that are sensitive to the effect of goodwill on earnings.

Recapitalization. Recaps combine many of the attributes of other financial restructuring techniques. They leave the public shareholders with a stake in the equity and they invariably enhance management's stake in the company. And in light of the fact that an equity stake is retained in the company, the returns need not be as high as they might have to be in an LBO or other total cash-out.

LBOs and sales of companies to third parties. These are the most radical options about which very little needs to be said. The labels are self-explanatory.

Joint ventures will increase in popularity, especially to achieve deconsolidation or to obtain a partner with cash to grow a core business.

Concerns about tomorrow

In restructuring, timing is everything. The key thing to focus on is not what happened in the '80s but what it means for the '90s. If you're going to restructure and restructure well, you have to be concerned about what's going to happen tomorrow. We have characterized the decade of the '80s as the decade of the hidden asset. We think the '90s might be the decade of the hidden liability. Here are some trends you may want to look out for:

Foregone capital expenditures. Managements have not just cut out the fat in terms of capital expenditures, they've gone to the bone in many, many companies. Turnarounds have been delayed. Maintenance has been reduced. We think it's going to come home to roost. If we're going to stay competitive, we have to fully fund capital expenditures.

Post-retirement benefits. This is a major issue. Most managements are focusing on it now, with the Financial Accounting Standards Board (FASB) proposing a change from cash to accrual accounting. You might say, "Big deal...Doesn't the market know we have this $500 billion to $2 trillion liability sitting there? It's always been there." While you can argue about ways in which the accounting should be changed, the fact is that it exists. Recognition of post-retirement health care and life insurance liabilities presents a substantial challenge in the 1990s. They will cause a number of companies to change their benefits to reduce future liabilities.

Environmental costs. This trend represents the privatization of environmental costs. While up to now we've mostly been paying for them with our lungs, as opposed to our cash, these costs will come home to roost for a number of companies.

Increased earnings volatility. If you have cut to the bone, if you have cut through all your variable costs due to market cycles (which some managements have forgotten actually do exist), you're going to have increased earnings volatility. There isn't any fat left to protect you in a down market.

Changing restructuring environment. What are the implications of all these trends? The restructuring market is evolving. It's changing. Some of the changes we may like, some we may not. But if you analyze carefully all the aspects of corporate legal developments, tax legislation, public policy questions, and market trends, we think you can come up with some new and creative restructuring approaches. We think the pressures to increase shareholder value will continue. There will be a new emphasis on strategic business combinations to emphasize long-term positioning in core businesses, including cross-border transactions. We think you'll see some restructuring to address financial and international accounting inefficiencies as well.

The privatization of environmental costs is a trend to look out for.

Tax, legal, and market trends

We also see the following trends emerging:

Tax legislation. With the potential for capital gains reductions, to the extent that we see new recapitalizations, we don't think they'll be highly leveraged. They'll involve some tax-free distributions — spin-offs and split-offs — or what is called disproportionate redemptions. Some of the very early recapitalizations — FMC Corp., Colt Industries Inc. — were disproportionate redemptions. You were able to categorize the distribution as a return of capital, as opposed to a dividend, and you could get capital gains tax treatment. There's a move in Congress to limit the tax deductibility of debt. You want to put your debt where you can get the deduction. There will be a number of financial products that will assist you in doing that.

Legal developments. It's definitely a more friendly environment in the wake of the Delaware court's decision on Polaroid Corp.'s takeover-blocking ESOP. The business judgment rule was strengthened following the *Time Warner* decision. Poison pills, if used properly, will be more effective. And there is increased use of antitakeover laws at the state level.

Public policy questions. These are pretty much up for grabs. Obviously, there will be much discussion about competitiveness, restrictions on financing, and limitation of leveraging in certain "key industries." What happens will be a function of how much noise is made. The great unknowns include the budgetary impact of a lessening Cold War economy and resultant European opportunities and obligations.

Market trends. By and large, we're looking at a weakening economy, relatively stable interest rates, and a somewhat uneasy feeling about inflation. Equity markets are perceived as being a bit toppy and potentially more volatile. Many companies are perceived as relatively fully valued — i.e., 80% of pretax breakup value. In the tiered junk market, there is no availability of funds or liquidity for highly leveraged credits. In this environment, you probably will be seeing more noncash currency used in transactions initiated for strategic purposes.

Newly attractive restructuring techniques. We think these changes in the market environment will make certain restructuring techniques very applicable. The common emphasis of these techniques will be the sharing of risk between buyers, sellers, and partners. Joint ventures will increase in popularity for a number of reasons, but especially to achieve deconsolidation or obtain a partner with cash to grow a core business. You will see greater use of parent or subsidiary stock as currency in exchange offers, new forms of equity consideration — such as the contingent value rights in the Dow-Marion transaction — as contingent compensation, and the use of noncash currency in such ways as to mitigate the negative financial and tax impact of a transaction.

In summing up, we think the days of the easy financial engineering type of restructuring transaction are pretty much over. We see continued emphasis on employees as owners, core business growth, and strategic restructuring to increase international competitiveness. ■

M&A

Due Diligence

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WHARTON REPROGRAPHICS

The Preacquisition Search For Environmental Risks

Frank L. Hearne and Douglas A. Dean

Air, water, and land pollution have become increasingly critical issues in consummating an acquisition, killing some deals and forcing renegotiation of others. To detect potentially costly problems and defuse ticking time bombs, acquirers and lenders are trying to get a handle on possible liabilities by up-front examinations of environmentally risky targets.

IN RECENT YEARS, federal, state, and local statutes, along with a growing body of common law, have introduced environmental issues as significant components of business transactions, including mergers and acquisitions. Too frequently, the acquirer that inherits air, water, or land pollution problems faces enormous cleanup costs that could reduce or nullify the perceived benefits of the target company. Because the risks are so great and the issues so complex, increasing numbers of buyers are commissioning environmental audits as part of the due diligence process, not only to catch existing problems, but to detect those that may arise in the future.

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Environmental issues confronting business acquirers cover wide swatches of legal and financial territories. Sites where soil and groundwater are contaminated by a broad range of chemicals or that contain leaking underground tanks can lead to staggering cleanup costs for the business entity that owns or operates them, many times even when the business is innocent. Numerous permits are required for continuous operation of many businesses, and the associated pollution control systems or operating restraints involved may be so costly that continued profitable operations are not feasible. There are significant civil and even criminal penalties for noncompliance that must be considered by responsible management. In certain states, such as New Jersey, compulsory environmental investigations and financial commitments to fund cleanups are required before a business deal can be consummated.

Concerns over assets used as collateral

Lenders and other financial backers are greatly concerned that environmental costs can render borrowers unable to pay or that the assets used as collateral will be impaired by cleanup expenses. Under case law involving the major federal cleanup law, the Comprehensive Environmental Responsibility, Compensation, and Liability Act, more popularly known as Superfund, lenders have been held directly liable for cleanup costs on foreclosed properties. A number of states have "Superlien" laws giving the state a lien to recover cleanup costs that

has priority over prior liens. Toxic tort litigation involving asbestos, benzene, and other products and building materials represents another area of large potential liability for the individuals and businesses involved.

Frequently, the environmental risks are recognized, at least in concept, for the chemical industry or for complex manufacturing facilities. However, many small, seemingly unrelated businesses may be involved with regulated substances or may require permits for continued operations. For example, dry cleaning establishments store, use, and discard an organic solvent that is regulated and can cause significant soil and groundwater contamination if handled improperly. Even undeveloped land can create problems because of earlier, but subsequently invisible, disposal of hazardous waste that was completely lawful when it was done. In fact, businesses in almost every industrial classification are involved with environmental compliance and liability to a significant degree.

These and other aspects of environmental liability require a careful analysis of a transaction to determine the financial risks involved, to obtain financing for the deal, and to achieve continued profitable operations. In many cases, the magnitude of these risks may be a major reason why the properties or businesses are offered for sale and may affect the structure and timing of the deal and the resulting business organization.

Fault may be irrelevant

There are several harsh, but fundamental, principles of environmental law that must be considered in the context of mergers and acquisitions. First, the major cleanup laws operate on the basis of strict joint and several liability. This means that fault is irrelevant and that a single innocent party involved in a contaminated site can be made to pay the government for everyone else's problems. There are very few defenses that can be used even by an innocent business to avoid cleanup-related costs.

Second, a very broad range of past and present players can be held liable for cleanup costs at a particular site. For example, let's say corporation A's activities contaminated a site in 1965 and the site was sold successively to corporations B, C, and D. Corporation D owns the site today but the facility is operated by corporation E, a lessee. Under Superfund and a number of parallel state laws, everyone, generally speaking, is liable to the government for cleanup costs. While corporations A through E can apportion costs among themselves in separate litigation, chances are that some of the players will be out of business or insolvent, leaving the remaining parties to pay both cleanup costs and substantial legal fees.

Third, cleanup laws are in effect retroactive. The courts have forced responsible parties to pay cleanup costs even when the activities causing the contamination, disposal of hazardous wastes, for example, were legal at the time.

Fourth, environmental laws and regulations change frequently, and to some extent, unpredictably. Major federal laws may be added as a consequence of the latest environmental disaster or scientific discovery. Agencies continually modify or refine regulations with varying effects. The courts have not had time to develop a reliable interpretation of many statutory and regulatory provisions.

When deals must close rapidly, there may be escape clauses that allow the acquirer to refuse to receive an asset, pending results of an audit.

Last, environmental permit and compliance issues are as important as cleanup liabilities. There are very complicated regulations involving, for example, wastewater discharge, air emissions, the generation, storage, transportation, treatment, and disposal of hazardous wastes, and construction in wetlands. The government's remedies for noncompliance can include stiff penalties and, in extreme cases, facilities can be closed down and environmental restoration required. Frequently, the pollution control systems necessary to receive the proper permits and comply with regulations may be quite expensive.

On occasion, properties or businesses may be selected for divestiture based on environmental matters. The owners may conclude that, based on developing environmental laws and regulations, the existing process will become unprofitable with the emission controls that will be needed. In another case, the seller may offer several profitable properties in a package deal that requires the buyer to take related sites that have serious environmental risks. Certainly, there have been, and will continue to be, cases in which businesses or properties are offered by a seller who knows they have significant environmental problems, but is nonetheless hopeful they can be transferred to an unsuspecting buyer.

How a Wary Buyer Sized Up the Problems and the Costs

by George Pilko

When the nation's fifth largest law firm, Gibson, Dunn & Crutcher of Los Angeles, was structuring the $440 million acquisition of a manufacturer of commodity and specialty chemicals, Pilko & Associates Inc. was called in to examine and assess the general environmental condition of the company's properties and operations.

The target company produced and marketed polyethylene, polypropylene, styrene, and plastic film, and was engaged in the development of petrochemical and plastics processes. The nature of the business alerted attorneys to the potential for costly hidden environmental liabilities to surface in the future. They responded by enlisting experts to conduct a thorough environmental risk assessment and identify any environmental issues that could require significant expenditures over the five years following the deal.

The environmental risk assessment included extensive onsite inspections of six manufacturing facilities. At the same time, our staff interviewed employees, reviewed pertinent documents, such as permits and groundwater monitoring data, and reviewed correspondence with state agencies. And regulatory agencies were contacted to gather information regarding the transferability of environmental permits and the mechanisms involved in negotiating the transfers.

No major health or safety issues were identified at any of the facilities. But significant environmental issues regarding potential groundwater contamination were identified at one facility and a potentially significant environmental permitting issue was identified at another. However, the remediation costs for resolving the environmental issues were deemed manageable and not enough of a liability to interfere with completion of the merger.

We estimated total capital expenditures for remediation of the groundwater problem and other issues to be in excess of $15 million for the following five years. Capital cost items were estimated to address high-priority environmental issues, largely related to groundwater, at one facility. In addition, estimates were made for other capital cost items that might be required for additional remediation during the following two to five years.

Another consideration was the possible banning of certain types of disposal operations by the Environmental Protection Agency. We estimated that would ultimately cost the company in excess of another $7 million in treatment costs.

The issue of representations and warranties also was addressed. The merger agreement provided that representations and warranties of the target company pertaining to environmental law matters expired upon consummation of the deal. The acquiring company assumed all environmental risks associated with the prior conduct of business by the company and its subsidiaries.

Results of the environmental audit were used by Gibson, Dunn & Crutcher in the required filing of a registration statement with the Securities and Exchange Commission in accordance with the Securities Act of 1933.

Substantially all of the financing for the acquisition was to be obtained through bank borrowings under a credit agreement and from the issuance of notes, preferred stock, and common stock. To that end, the results of the environmental assessment were submitted to investors so they would understand that all significant environmental issues had been identified and that problems were manageable.

The assignment did not end with completion of the deal. Several months after the acquisition, the acquirer proposed a public offering of common stock to provide funds for retiring debt. Pilko staff members were summoned to discuss the environmental issues and related costs with financial analysts. In this way, the analysts were able to obtain a clearer understanding of the company's financial risks. ■

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Environmental concerns also may be a factor in selecting the acquirer's ultimate business organization. Mergers involving companies with unknown or unquantifiable environmental liabilities will, in many cases, expose the assets of the surviving company. The corporate veil, in most legal situations, would protect the parent corporation from the liabilities of a subsidiary. But this general principle is not clearly applicable to environmental liability.

Federal and state agencies continue to push the courts toward holding stockholders and parent corporations liable for cleanup costs. While the issue is by no means settled, there are cases holding stockholders liable. In this context, business structuring should involve legal advice by attorneys that understand environmental liability.

A facility can be treated as a "black box" that is monitored for materials flowing in, activities and conditions onsite, and materials leaving by various routes.

Insurance has not provided an appropriate and reliable means to control environmental risks, at least for the past five years. In the past, the typical businessman would expect such risks to be covered under comprehensive general liability (CGL) insurance because they did not fall under other traditional policy coverages. Beginning in the early 1970s, CGL policy firms added exclusions denying coverage for certain types of pollution-related losses. Predictably, these exclusions have been the basis of extensive litigation by companies on the line for billions in cleanup costs. The cases have produced mixed results, sometimes awarding coverage and sometimes denying it.

The response of the insurance industry was to revise and broaden the pollution exclusion in CGL policies in an attempt to exclude totally all types of environmental losses. In the early 1980s, an insurance product tailored specifically for environmental impairment liability (EIL) was introduced. This coverage was available for only a short time and was discontinued in recent years. Today, EIL is slowly becoming available once more and will probably be a factor in managing environmental risks for sites that qualify in the future.

In the face of the financial risks, investors, acquiring companies, and other involved parties increasingly are turning to legal and technical investigations to assess the environmental liability and compliance status of a business targeted for acquisition. These environmental due diligence investigations are still in the early stages of development, but, in most larger deals, environmental lawyers, engineers, and scientists frequently are involved because of the specialized knowledge and capabilities that are needed.

The examination often is referred to as an "environmental audit," employing a term used by industry for ongoing review of environmental compliance in operating facilities not being offered for sale. Sometimes, it is called "environmental due diligence" or a "site assessment." Whatever term is employed, the investigation is a useful tool for assessing and managing environmental risk in today's regulatory and litigation climate.

A properly conducted environmental audit also may provide innocent purchasers some protection from Superfund liability. Originally, the Superfund statute allowed a limited defense to liability for cleanup if the release and damages involved were caused by the act or omission of a third party who was not in a "contractual relationship" with the defendant. Defendants also must meet certain other requirements of the defense by proving that they took precautions against foreseeable acts or omissions by the third party involved.

Because land transfers involve contracts, that defense was unavailable to innocent land owners who acquired property after it became contaminated. In a new definition of "contractual relationship," recent amendments to the Superfund law provide some protection for innocent property owners if the new owners are among three distinct groups. These are:

☐ Defendants who did not know and had no reason to know that there were hazardous substances at the site;

☐ Government entities that acquired the property involuntarily or by exercise of eminent domain; and

☐ Owners who inherited the property.

Using examination as a defense

To establish that the defendant had no reason to know, the law states that "the defendant must have undertaken, at the time of acquisition, all appropriate inquiry into the previous ownership and use of the property consistent with good commercial or customary practice in an effort to minimize liability." Among the factors that a court could consider in determining whether the defense is available are:

☐ Specialized knowledge or experience of the defendant;

☐ The purchase price of the property or business if it was not contaminated;
☐ Commonly available or reasonably ascertainable information about the property;
☐ Obviousness of the presence or likely presence of contamination; and
☐ Ability to detect such contamination by appropriate inspection.

Cleanup liability is gray area

It would appear that if the purchaser has conducted an adequate inquiry for its knowledge and circumstances, the defense would be available, assuming the other conditions also are met. Cases are beginning to appear that interpret this provision, but no clear guidance has emerged as to the extent of the inquiry courts will require. The Environmental Protection Agency also has declined to issue any classification.

Although the amendment provides some comfort as to Superfund liability and encouragement for environmental auditing, it by no means solves the complex problem of cleanup liability. The defense is applicable only to Superfund actions by the government. At many sites, the defendant still may be liable under other provisions of federal law.

Furthermore, the defense is not operative at all against state cleanup law actions and will have an unclear effect, at best, on private tort litigation. Finally, regulatory compliance issues involving, for example, proper water discharge permits, are unrelated to cleanup statutes and represent separate financial vulnerability.

Just what is involved in an environmental audit? The answer depends to a great extent on the facilities and properties involved. Two types of audits are most common and either can involve a single property or multiple sites:
☐ Liability-based audits including soil and groundwater contamination assessments focusing on cleanup liability either at owned sites or offsite disposal facilities that have received wastes. Other liability issues may also be reviewed such as asbestos in structures.
☐ Environmental compliance assessments focusing on operating facilities owned by the target business that are reviewed for permit and compliance purposes.

In an audit focusing on soil and groundwater contamination, a phased approach is both cost-effective and helpful in reducing the tension between the parties to a transaction.

During Phase I, the buyer or its consultants will visit the site, search government agency and title records regarding the site, review the seller's records (if so agreed), and interview people involved in the operation. A number of very useful facts can be obtained in this way without onsite sample collection of soil and water. The seller is somewhat comforted by not sampling at this stage because if contamination is discovered, state and/or federal law may compel him to report it. However, the buyer may discover enough during this process to determine it is no longer interested. (For example, government records may indicate a large solvent spill that was never corrected.)

If the parties are still comfortable, soil and groundwater sampling efforts can be focused during Phase II on the specific chemicals that may be expected — based on the investigation of records and the site visit. It is important when targeting substances in Phase II to consider possible offsite sources. The owner may become involved in expensive litigation, even if the contamination moved into the property from offsite. In many cases the owner can be made to pay cleanup costs even where the contamination is offsite.

Finally, if contamination is detected, the parties may do further tests to estimate cleanup costs in Phase III. During the third phase, the goal would be to estimate the areal extent of the contamination and predict cleanup standards and the appropriate cleanup technology. Rough estimates of cleanup costs may be obtained.

Practically speaking, this type of audit seldom

A Casualty of Financing Reluctance

Probably the best-known case in which potential environmental liabilities scotched a major deal was the breakdown of the proposed sell-off of Koppers Co.'s chemical business in July 1988. Beazer PLC, the British concern that acquired Koppers the month before, had cut a deal to sell the chemical operation to the division's management and Sterling Group of Houston for $660 million. Although neither side officially acknowledged why the deal fell through, it was widely reported that the buyers could not swing the financing from lenders who were worried about environmental issues. M&A

proceeds exactly as presented. Many times, sampling will be indicated during the first site visit. For sites with known contamination, the effort may be concentrated in Phase III and focus primarily on estimating costs of cleanup. The parties then can deal with these costs by contractual means. In many cases the parties will proceed to an agreement implementing a cleanup at the site.

The objective of a comprehensive operational environmental audit is to ascertain the degree or status of a facility's compliance with all statutory and regulatory authorities to which it is subject. As an overview, it is useful to remember that environmental regulation of an operating facility generally results from an intent to control:

- Materials *entering* the facility, such as hazardous materials or solvents;
- Materials, personnel, activities, and conditions occurring *onsite*, such as worker and public right-to-know, processes, or spills of fuels or other materials;
- Effects on *site attributes*, such as wetlands or zoning considerations; and
- Emissions and wastes *leaving* the site, such as air emissions or wastewaters.

Through usage of the comprehensive approach, a facility can be treated as a "black box" that is monitored for materials flowing in, activities and conditions onsite, and materials leaving by various routes. The major environmental statutes essentially control one or more of these four topics.

The buyer may discover enough during the process of sampling soil and water to determine it is no longer interested in the target.

The exact procedures for a particular audit are driven by a variety of factors peculiar to the individual case. These include the extent of the audit (the company may want to focus on a particular aspect such as waste and wastewater treatment and discharge), time and budget restraints, and other factors. However, the following lists the general elements that are usually present:

Audit Planning. The parties must plan and schedule the audits. Legal counsel should be involved to consider confidentiality for the acquiring company that wants to know all it can about environmental compliance and soon will become an owner with potential obligations to report certain damaging data to government agencies. The management team of the target business should be assembled and the participating employees should be identified.

Management of the seller should take the steps necessary to obtain cooperation by employees and access to facilities and records.

Audit Team Selection. Based on a preliminary review of applicable regulations, the proper personnel with appropriate expertise and experience should be assembled. For a complex facility this may include several individuals. A typical team for a major manufacturing facility or utility might include a wastewater engineer, a hazardous waste engineer, an air emissions specialist, and an industrial hygienist. When multiple facilities or sites are involved, it is best to have the same individuals involved or have significant overlap of team members in order to be as consistent as possible.

Analyzing the regulatory aspects

Information Review and Regulatory Analysis. At this stage the audit team will perform a detailed review of applicable regulations and liability concerns. Federal, state, regional, and local law will be assembled, focusing upon the operations and conditions at the facility. During this process, the audited company must provide detailed information concerning its operations. Typically, this would include descriptions of key personnel and their responsibilities; copies of permits, reports, and enforcement records; process descriptions, diagrams, blueprints, and plant layouts; aerial photographs; hazardous waste records; and other materials. Key employees will be identified for interviews.

Development of an Audit Protocol. A guidance manual or checklist will be developed. This document draws together regulations and operational data into an audit protocol, which will be used to guide the auditors and to make sure that all of the appropriate environmental information is developed. For audits involving two or more facilities, the methods of data collection must be consistent so that audit findings can be compared. It may be necessary to acquire more information or clarification of the audited company. When appropriate and economical, the audit protocol can be computerized to enable the auditor to produce a preliminary report on the spot following an inspection. Appropriate legal counsel should review all audit reports, including the site inspection report.

Facility Inspection. During this stage, the audit team will visit the facility and perform its inspection.

The team also may review documents and files too lengthy to transmit. Interviews with key personnel will be conducted. Senior employees at all levels are useful sources of information, especially in the case of investigation of liability for past practices. A period of time should be allowed for a response by the audited company to potential issues identified during the site inspection. There may be explanations or further data that would clarify the deficiency.

Audit Report. An audit report will be prepared to identify the areas where deficiencies have been found. Again, legal counsel should be involved in the review and format of the document to minimize future liabilities. Sometimes, a management consultant may be enlisted to evaluate the company's reporting and decisionmaking procedures and organization.

Practically speaking, the compliance audit does not ususally proceed in such pure step-by-step manner. For example, it is not usually necessary to develop a detailed protocol from scratch. There are several basic forms available and experienced consultants often will have applicable forms that can be fine-tuned for a particular case.

Deals involving sophisticated parties often will involve both environmental legal counsel and qualified technical consultants. As with many aspects of a complex deal, the acquirer, the lender, and the target company should have independent advice on both fronts. In some cases, multiple independent audits are conducted; in others, there will be a primary audit, which is reviewed by legal and technical advisers to the parties.

The parties in an acquisition also can elect to cope with environmental risk in contract documents. When deals must close rapidly, there may be escape clauses that allow the acquirer to refuse to receive an asset, pending results of an audit. If all or some of the audits results are in, the parties have a number of options to allocate risks and costs based on improved information. There may be a negotiated price adjustment to offset the cost of cleanup or improved equipment. Money may be placed in escrow to pay for cleanup conducted by the acquirer.

Other deals involve a phased transfer of liability in which the acquirer pays for, say 10 percent of liabilities incurred in the first year, 20 percent in the second year, and so forth. A common term will provide for an indemnity for the acquirer in cases where the selling company has adequate resources.

Impact on finances

Still, other contractual mechanisms are being developed as experience with environmental liabilities increases. In some cases, there may be insurance proceeds available to pay for a cleanup that should be considered in the deal. The availability of such funds may be subject to the status of pending coverage litigation with the insurers, depending on the type of insurance involved.

In summary, a complex of federal, state, and local laws requires careful attention to environmental liabilities and compliance in mergers and acquisitions. A broad range of businesses are subject to these laws. These issues may affect the financial viability of the business resulting from a merger or acquisition and should be considered extensively in structuring the deal and the ultimate business organization. Depending on the positions of the parties, the relevant contracts should contain exact terms addressing the risks.

Environmental due diligence and environmental audits involving qualified environmental legal and technical assistance can help in assessing and coping with the liability involved. Consequently, those participating in m&a transactions increasingly are demanding environmental audits as key factors in successful deals. ■

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WHARTON REPROGRAPHICS

Preventing Culture Clashes From Botching a Merger

Caren Siehl, Gerald Ledford, Richard Silverman, and Peter Fay

Corporate culture is hard to pin down even when companies don't merge. When two firms of obviously different cultures get together, ignoring the potential for friction could be disastrous.

WITH INCREASING FREQUENCY, the clash between the cultures of acquiring and target companies is being identified as a major cause of acquisition failure. The difficulty in resolving such conflicts often is compounded by the fact that culture, in its broadest sense, defies easy definition and analysis. In many cases, the cultural clash may take the form of differences in the way the two companies operate. But in others, the differences are far more subtle and even their identification may prove to be elusive.

Before going into a detailed analysis, it is useful to begin by describing two cases in which rather clear cultural differences plagued postmerger performances. One case is Fluor Corp.'s "white-knight" acquisition of St. Joe Minerals Corp. in 1981. Although both companies were reputed to have first-rate management, their cultures were undeniably different. St. Joe's relatively lean headquarters organization ruled with a light hand, while power resided with a huge corporate staff at Fluor. Fluor maintained a fleet of aircraft for its staff; conversely, St. Joe did not even have a limousine for its chairman. The St. Joe operation was small and tight, almost like a partnership, and decisions could be made very quickly.

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Going to extremes

Initially, Fluor allowed the mining company great autonomy. Requests by Fluor personnel for nonroutine information from St. Joe had to be cleared by one of two top Fluor executives. Gradually, however, Fluor went to the opposite extreme, and St. Joe's autonomy faded. The erosion of autonomy was accelerated by a worsening financial situation at both St. Joe and Fluor that resulted from weakened markets. It became difficult to support two separate staffs. When the St. Joe staff did not appear to move as fast as Fluor wanted, Fluor managers took control. Ironically, Fluor recently has become more decentralized, and its culture is becoming more like St. Joe's in response to hard times.

The second case is the friendly acquisition of a consumer products company we will call "Hammer

Inc." by another major consumer products company with the pseudonym "Appliances Inc." Although managers of both firms used some of the same words to describe their values, they spoke essentially different languages. A key example of how such cultural differences influenced the integration process at Hammer involved how product quality was understood in the two companies.

The emphasis on quality by Appliances reflects its strong marketing culture, with customer loyalty built on product quality. Quality is broadly conceived; the espoused "total quality" approach is intended to insure that Appliances is seen by outsiders as a "first-class operation" in every way. As at International Business Machines Corp. and other marketing-oriented firms, the emphasis is on looking good while doing well. As at General Electric Co., top management is dedicated to being No. 1 or No. 2 in every market it enters, and the businesses receive heavy investment to develop products that will build or maintain market share and margins.

The meaning of quality at Hammer reflected its position in a commodity segment of its market. As a commodity firm, it competed mostly on price; quality meant adherence to uniform, generic product standards. Appliances managers felt that there were opportunities for Hammer to earn high margins by developing new, premium products. However, Appliances found it very difficult to transfer the concept of marketing quality brands for a premium price, despite the training and coaching of Hammer managers. Managers in the acquired firm felt that they already produced "quality products."

Other differences arose from Hammer's view that low profit margins should be raised by increasing production volume and reducing costs, rather than by investing in costly capital equipment or in marketing — steps that were central to the total quality concept at Appliances. The acquiring company's managers knew that capital investment had been low but they were unpleasantly surprised when they finally examined the condition of Hammer's capital equipment. To Appliances managers, the need for more investment was obvious, even if it raised costs in the short run.

Barrier to success

Appliances executives found that such cultural differences hampered their ability to help Hammer resolve its operational and financial problems — and thus interfered with their ability to recoup their investment in Hammer. The difficulties of integrating Hammer led senior Appliances management to rethink how they went about making and integrating acquisitions and they were more successful in later deals.

A key problem in some acquisitions, then, is ineffective management of cultural integration. In order to better understand the problem of cultural integration, we will discuss:

— A working definition of organizational culture and cultural integration; and

— Avoiding trouble spots in the management of cultural integration.

The term "organizational culture" is used in many different ways by researchers and practitioners. However, most observers agree that the phenomenon of culture is complex and difficult (some say impossible) to manage. This means that there is no simple definition of organizational culture.

In the General Motors-Hughes Aircraft merger, "silver seat belts" were created to provide $250 million in incentives for top people.

Some researchers and practitioners suggest that organizations should be conceptualized as cultures. They favor the view that culture is something an organization is, rather than something an organization has. Those who argue that culture is a socially constructed system of shared beliefs and values would find it inconsistent to think of systematically developing or attempting to control the phenomenon.

However, other researchers and managers, particularly those searching for predictable means of organizational control and improved methods of management, hold the belief that culture can to some degree be managed. This view of organizational culture stems from the belief that organizations produce cultures. Culture is defined as the social or normative glue that holds an organization together. Culture can be thought of as a magnet that holds a company together through shared patterns of meaning. We will adopt this perspective on culture.

Edgar Schein has identified three levels of culture: basic assumptions, values, and artifacts. We will add a fourth category, perceptions of company practices.

Espoused and Inferred Values. Espoused values are those values that employees say they believe in.

Espoused values are communicated directly. For example, top management might espouse values through a statement of corporate objectives or management philosophy. Such values define the basic philosophy or mission of the company. Inferred values are those values that are inferred from employee behavior and from the second and third components of culture: cultural artifacts and employee perceptions of company practices.

Cultural Artifacts. Cultural artifacts, the second component of culture, are indirect, implicit, and subtle means of expressing values. Such artifacts include jargon or a special language, organizational stories, rituals and ceremonies, and humor. Although people often consider these to be unimportant, cultural artifacts can be the key to understanding employees' reactions to the espoused values of top management.

Employee Perceptions of Company Practices. Values also can be inferred from the third component of culture, employee perceptions of company practices, that is, the everyday activities of the managers of the company. The most enduring and impactful practices are a firm's human resource system. Specifically, such practices include selection procedures, training programs, performance appraisals, compensation, and promotion procedures. Management may espouse a set of values that are incongruent with employee perceptions of the values being expressed and reinforced by management practices. This would result in espoused values and inferred values being in conflict. On the other hand, management's espoused values may, in fact, be reinforced by the values expressed through company practices.

Identifying the subcultures

A distinction needs to be drawn between an organization's dominant culture and the various subcultures that may coexist with it. A dominant culture expresses core values that are shared by a majority of the organization's members. Subcultures include:

Enhancing. This exists in a subgroup of the organization in which adherence to the core values of the dominant culture is more fervent than in the rest of the organization.

Orthogonal. The members simultaneously accept the core values of the dominant culture and a separate, unconflicting set of values particular to themselves. For example, an accounting division and a marketing department both may endorse the values of their firm's dominant culture, while creating separate sets of values related to their functional units.

Counterculture. The core values of a counterculture present a direct challenge to the core values of the dominant culture. The two exist in an uneasy symbiosis, taking opposite positions on value issues that are critically important to both of them.

Diagnosis and management

Organizational culture, then, is highly complex, and difficult to understand and manage. But if managers hope to use the concept of culture to help select potential acquisition targets or to manage postmerger integration, they need to know how organizational culture can be diagnosed and managed.

There are several areas in which human resource expertise can be helpful in managing acculturation. These areas include:

Understanding Specific Situation Needs. The specific steps that should be taken in any acquisition should be determined by the business basis for the merger as well as by the culture of the acquiring firm. In some types of mergers, as when the acquiring company is interested only in the financial assets of a target company and expects to lay off most or all employees, extensive efforts to manage culture in the acquired firm are fruitless. In other situations, when a true corporate "marriage" is desired, attention to the management of culture is critical and a wide range of tools must be brought to bear.

Culture Diagnosis. Assuming that the acquiring company does plan to manage the cultures in the acquired firm, cultural diagnoses of two kinds is important. First, the acquiring organization must diagnose its own culture before searching for acquisition candidates. Conducting a self-diagnosis can suggest what cultural characteristics of a target are most important to an acquiring firm, what characteristics it wants more of, and how possible acquisitions may present problems or may reinforce cultural characteristics and directions desired by the acquirer. Second, a diagnosis of the culture of target organizations should be conducted. The diagnosis can begin in preliminary form prior to the acquisition agreement and can be conducted in earnest following the announcement of the deal.

Managing Perceptions of Company Practices. To reduce acquired employees' fears and uncertainty, it is important to develop and communicate plans concerning policies about job security, career opportunities, and any special compensation for early retirement or layoffs that may be available. The

human resources professionals probably will help determine whether changes are needed in the training, labor relations, compensatiton, staffing, and other personnel policies and programs of the acquired firm. In some situations, it is desirable to help create special human resources programs that reinforce acquisition goals. For example, in the General Motors-Hughes Aircraft merger, "silver seat belts" were created to provide $250 million in financial incentives for the top 1,000 managers, scientists, and engineers in Hughes to remain with the company for up to five years.

The core values of a counterculture present a direct challenge to the core values of the dominant culture.

While all of these activities are important in themselves, it follows from our definition of organizational culture that these policies and practices also help to shape the nature of cultural integration between the acquired and acquiring firm. The way in which all the normal HR tools are used reflects the culture of the acquiring company, and symbolically displays the culture to employees in the acquired firm. For example, does the acquiring firm truly show concern for people in the way it is making and communicating merger-related decisions? Similarly, espoused values of decentralization, entrepreneurship, and innovation may be in conflict with attempts to impose the buyer's human resource policies on the target.

A recent acquisition provides an example of how an understanding of organizational culture can advance postmerger integration strategy. The acquiring firm made a conscious attempt to understand the culture of the acquired company and to transmit its cultural values to the acquired company. The buyer, whom we'll call Movies Inc., operates upscale family-oriented entertainment facilities. The acquired firm, which we will designate Acme Inc., occupied a narrow niche of the entertainment business.

The acquisition was friendly and both sides believed the deal was advantageous. Acme lacked the capital to take advantage of growth opportunities. Movies was willing to invest the needed capital for the opportunity to enter a new business. Both Movies and Acme were financially successful, catered to similar types of customers, espoused entrepreneurial and family-oriented values, took pride in their business successes, and believed that they communicated well with their employees.

The president of Movies requested the assistance of the corporate human resources staff group in developing a strategy for postmerger integration. The alternatives ranged from operating Acme as a completely distinct, independent subsidiary (the conglomerate approach) to "love and marriage" — a true merger of the operations of the two companies.

The two CEOs agreed that they wanted a strategy of "cooperative independence," which meant embracing reciprocity, mutual respect, caring, and mutual problemsolving. They also agreed that they would act as gatekeepers between their respective organizations during the transition period. Since both organizations were successful in their own right, there was no immediate need for quick "fixes." So, "hands off unless invited" was a message communicated to the staffs of the acquiring company; the integration process would be driven by top line managers.

A detailed plan for postmerger integration was developed. It included three elements:

— How the newly acquired business would be managed;

— How the transition would be executed; and

— How individual employee concerns about job security and career advancement would be addressed.

Careful attention was paid to methods of communicating the cultural values of Movies to the acquired company. Similarly, care was taken to demonstrate the acquiring company's respect for the culture of Acme. The implementation process began the day the merger was announced.

A communications meeting

The announcement was followed by a formal communications meeting in Acme headquarters that was intended to transmit the rationale for the acquisition, and also to point out the cultural synergy and differences between the organizations. The meeting was designed as a major ceremony that would communicate values in direct, as well as symbolic, ways. Both employees and spouses were specifically invited to the meeting; this reinforced the espoused "family" value of both companies. Both presidents "brought out their best" with in-depth professional analyses and overviews of their businesses. The presentations emphasized the future expansion of the acquired company and the need for capital for the family to grow. Both presidents re-

peatedly mentioned quality services and products as a means of retaining and expanding market share.

Immediately following the question-and-answer period, a banquet was held for the employees and their spouses. The banquet was designed to facilitate culture transfer, especially the value placed on communication. Rather than a sit-down dinner, a buffet was held to facilitate mixing and to increase the number of people the acquiring president could meet personally. Ten other Movies executives who were selected as organizational leaders and good communicators also were present to answer questions. They previously had been briefed on specific answers to the questions most likely to be asked by Acme employees, on such issues as continued job security and opportunities for career enhancement. The support executives circulated and answered questions for as many employees and spouses as possible.

Holding structured interviews

During the following week, employees were invited to attend voluntary, "one-on-one" communication sessions with the acquiring company's human resource staff. The sessions consisted of structured interviews to:

— Elicit personal concerns about the acquisition (pay, pensions, careers, etc.);

— Solicit cultural and subcultural artifacts, such as jargon, humor, history, and stories;

— Identify means of making the merger more successful for interviewees and their organizational subunits; and

— Transmit cultural values and norms of the acquiring company on a more personal basis. Indeed, the sessions themselves were symbolic of the values of open communication and respect for the culture of the acquiring firm.

More than 150 interviews were conducted and summarized anonymously and made available to both CEOs. These data were valuable not only in helping manage the human side of the merger process, but also in gaining Movies a better understanding of the special business needs of Acme. The acquisition of Acme went smoothly, even though there was inevitable employee stress and uncertainty over the deal.

Predictable Trouble Spots to Be Avoided. Acquiring organizations often find that the culture of an acquired organization is being poorly managed. Alternatively, the acquiring organization may attempt to change the culture of the acquired organization for any number of reasons. In either case, an important issue becomes "how can culture be managed?"

At IBM and other marketing-oriented firms, the emphasis is on looking good while doing well.

There are four predictable trouble spots in the management of corporate culture:

— The absence of a clear and internally coherent set of espoused values;

— Overreliance on direct methods of communicating values;

— A dysfunctional conflict between the espoused values of top management and the values being inferred from the actual practices of the firm; and

— The existence of pockets of ignorance and pockets of resistance.

One of the most important and difficult tasks of top management is to decide what values should be shared, what objectives are worth striving for, and specifically what values should be espoused. Companies need a clear and internally coherent set of values. Without a clear set of values, employees can work at cross purposes. Without internal coherence, a set of espoused values can increase the confusion of employees.

Acquisitions can raise these issues in several ways. The acquired company never may have articulated its values in a clear and convincing fashion when it stood alone. In this case, it may be important for the acquiring organization to help the target understand itself better to deal with issues of identity and acculturation that the acquisition process inevitably raises. Second, the espoused values of the acquired organization may be different from the buyer's and that sets the stage for a conflict of cultures.

In different ways, the Appliances-Hammer and Movies-Acme cases illustrate the importance of clearly espoused values for successful acquisitions. The values espoused by Movies were similar to those espoused by Acme. It was relatively easy for the president of the two organizations to agree on both the values that should be espoused in the combined organization and the process by which these values would be communicated. This greatly facilitated integration of the acquisition and communication with Acme employees about the implications of the deal.

However, there were differences in the espoused values of Hammer and Appliances that reflected the orientation of Hammer toward commodity production and Appliances toward marketing. These differences were reflected in the meaning of basic terms such as "quality" and were a major source of conflict. Appliances went to great lengths to insure that the differences were understood by Hammer executives, a necessary step in changing the culture of Hammer in a direction that widened business opportunities.

If top management has selected a clear and coherent set of values, it needs to communicate them to employees in a convincing fashion. Many managers prefer direct methods of communication; if they have something to say, they say it. Such direct methods of communicating values often are greeted with skepticism and may be dismissed by employees as corporate propaganda. Managers who rely heavily on direct methods of communicating their espoused values run the risk of being ignored.

Indirect methods of communicating values can be more effective in having employees remember and believe what is being said. Indirect methods include the use of cultural artifacts and company practices to convey value messages.

Those who argue that culture is a socially constructed system of shared beliefs and values, find it inconsistent to think of attempting to control the phenomenon.

It is important to use both direct and indirect methods of communicating the values of the acquiring organization to members of the acquired company. Employees of the acquired firm are likely to experience a great deal of anxiety and uncertainty following the merger. They want to hear directly what the new management stands for — even if they prefer to "wait and see" whether the new management acts in a manner consistent with its espoused values. However, indirect methods of communication are equally important in this situation. Employees of the acquired organization are likely to be unusually alert to signals from the acquirer, and may read more into specific behaviors than is appropriate.

The Movies-Acme case suggests ways in which communication about the acquisition can be managed to transmit cultural values, both directly and indirectly. For example, there is little doubt that the espoused value of "family" was communicated in a far more memorable fashion by demonstrating it — via invitations to spouses to attend the communications meeting — than simply by verbalizing it.

Discrepancies between espoused values and the values being expressed through cultural artifacts and practices can be dysfunctional. When management espouses values that are not translated consistently into management practices, employees can be put into a double bind. They cannot trust what management says and they do not know whether to translate espoused values into action. In such cases, the discrepancy easily can be dysfunctional for employees at all levels of the firm, causing a kind of cultural schizophrenia. Again, employees can be expected to be unusually alert to apparent discrepancies during the acquisition process.

Pockets of resistance

The 1984 acquisition of ROLM Corp. by IBM provides a good example of sensitivity to this pattern. A general manager of a sales unit eliminated free coffee as part of an effort to trim costs but reversed the decision when employees blamed IBM. He thus avoided sending the wrong signals to a work force that was highly concerned about losing its culture.

Employee reactions to management's espoused values and the values being expressed and reinforced through cultural artifacts and company practices may lead to pockets of ignorance or pockets of resistance. If employees are unaware of the values of top management, a pocket of ignorance will arise. If, however, employees are aware of the values, but do not agree with them, a pocket of resistance may be created. Within the pocket of resistance, subcultures may develop that focus on values conflicting with the values of the dominant culture.

The first step in dealing with these problems is to determine where in the organization pockets of resistance and ignorance are located. The next step is to determine the source of the problem and deal with it accordingly.

Acquisitions can complicate the normal political dynamics that are associated with attempts to decrease pockets of resistance to the organization's culture. Rival factions are likely to see different risks and opportunities in the acquisition. In particular, those residing in pockets of resistance may see opportunities to gain strength by alliance with the acquiring organization, especially if their values are more closely aligned with the values of the buyer than the target. The degree to which the acquiring organization may attempt to exploit these dynamics

in a "divide-and-conquer" strategy will depend largely on the methods of acculturation used.

A recent example of managing culture in order to avoid pockets of resistance is the case of Unisys Corp., the company that resulted from the 1985 merger of Burroughs Corp. and Sperry Corp. Michael Blumenthal, chairman and CEO of Burroughs, believed that it was critical to have a true merger of the operations of the two companies in order to retain customers and talent from both companies.

One key concern was that dysfunctional pockets of resistance not develop around the cultures of the two merger partners. Thus Blumenthal and other managers took a number of actions to establish that the interests of the combined company (temporarily named Newco) took precedence over narrower political interests of either Burroughs or Sperry. He developed a superordinate goal that employees of the combined organization could rally around, namely a crusade against IBM. A transition team of top managers from both companies and 13 middle-management task forces representing both companies worked from June through September 1986 to recommend ways of combining Burroughs and Sperry. Then, as described in a recent article by Buo Uttal in *Fortune*, "when Blumenthal met with the task forces last September to hear their reports, he went along, producing boxes of symbols — baseball caps bearing both the Burroughs and Sperry logos. Whenever a manager started building up one company at the expense of the other, Blumenthal would bark, "Put on your Newco hat." The phrase became a slogan to defuse rivalry."

Finally, top management made it clear that people who attempted to protect turf would be dismissed.

Organizational culture can be a powerful force in shaping organizational behavior, but by its nature, it is difficult to understand, diagnose, and manage. Cultural analysis requires analytical skills as sophisticated as those required for financial analysis, but managers tend to have less skill in understanding culture than in understanding financial results. Diagnosing organizational culture takes time — a few months at a minimum. The necessary diagnostic data may be difficult to obtain if those in the acquired organization feel hostile to or threatened by the acquirer.

Managing organizational culture takes even more time. Culture changes relatively slowly in the best of circumstances. A culture change involves a rethinking of the most basic assumptions about an organization. There is no guarantee that the members of the acquired organization will support the types of changes desired by the acquiring organization, no matter how sensible such changes appear to the purchaser. At best, changing organizational culture is difficult and uncertain, but it is potentially critical to the success of the acquisition. ■

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WHARTON REPROGRAPHICS

The Strategic Sweep Of Dealmaking In the Middle Market

Russell J. Warren

Newly intensifying business pressures on both buyers and sellers are driving acquisitions of mid-sized companies in the 1990s.

More than 90% of reported mergers and acquisitions are valued between $5 and $100 million, the size most often associated with the term "middle-market companies." Two types of businesses typically are sold in the middle market — family and privately owned stand-alone companies and operating units divested by major corporations. Typically, these businesses are manufacturers and distributors of the myriad consumer products and industrial goods which permeate the U.S. economy and provide a significant number of good-paying jobs.

If the demographics of the m&a middle market haven't changed, the dealmaking environment has. Unlike many mergers and acquisitions of the 1980s within this mainstay of the American economy, middle-market deals of the 1990s are more strategic — fed by several new economic drivers that are falling hard on mid-sized companies — and are less financially driven. This means that they are more complex, costly, and time-consuming, yet offer less risk and more economic value-added opportunity — if done well. In short, they require a different, more rigorous process.

Four powerful new forces, overlaid upon traditional ones, are driving many businesses to seek strategic middle-market acquisitions, alliances, or mergers.

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SHIFTING WINDS

A fertile ground for financial buyers in the 1980s, the middle market today is dominated by highly strategic acquisitions. Whether buyers or sellers, mid-sized companies are being forced to respond to powerful business changes that include:

- Narrower lists of suppliers to big companies;
- Rapid and more expensive technological advances;
- Globalization of markets; and
- Strategic initiatives by financial buyers.

The middle-market environment of the 1990s requires more rigorous m&a analysis, and deals take longer to complete. But risks are lower and value-creating opportunities are greater.

Large Customers Are Winnowing Supplier Lists

To remain globally competitive, major corporations are forging close working relationships with fewer suppliers than in the past. Preferred suppliers along the value chain consistently provide high-quality products and excellent service at a good price. In discussions with a number of CEOs of large multinationals, we hear again and again, "We want to deal with fewer, larger suppliers." "It's just too expensive to buy a few items from a whole lot of smaller suppliers."

Rubbermaid Inc. CEO Wolfgang Schmidt said at the company's 1994 annual meeting, "Over the next three years, we will reduce our supplier base by 80%. This should allow us to achieve a sustainable 15% cost reduction in our purchases and create the opportunity for achieving total business partnerships with our strategic suppliers." These outsourcing alliances are gathering speed in the automotive, electronics, clothing, food, chemicals, capital equipment, pharmaceuticals, mass retailing, aerospace, and home appliances industries.

Such mega-customers want suppliers who are relentlessly dedicated to product quality, are ISO 9000 certified (or are in the process of getting that stamp), keep just-in-time delivery schedules, utilize direct electronic order entry, offer competitive prices, and are environmentally correct and financially stable. These world-class attributes translate into size, money, and sophisticated resources.

The trend by many of the largest companies toward creating outsourcing alliances is causing many middle-market businesses to consider acquisitions, sales, or other strategic transactions to strengthen their core businesses and better position themselves to be among the favored few suppliers.

Even as the number of suppliers dwindles, the pace and cost of technological change is accelerating, further increasing consolidation pressures. Product life cycles and product-to-market cycles are becoming shorter. And each succeeding technological development tends to be more costly. For example, when the original equipment manufacturer (OEM) users of electronic components switched to surface mount technology in their product, the trend forced component manufactures to make significant threshold investments, which were difficult for small companies.

In other words, whatever their size, technology-driven businesses must ante up to stay in the game. If a $2 million investment in new product development costs and equipment did the trick five years ago, it now can take $5 million to carry the initiative over the next several years. Again, a strategic acquisition, sale, or alliance could be the best way to remain competitive.

Many middle-market North American businesses see both opportunities and pressures being generated by the North American Free Trade Agreement (NAFTA), as their industries and markets expand internationally. Europeans are facing similar opportunities and pressures within the Common Market. Recent multinational approvals of the General Agreement on Tariffs and Trade (GATT) clearly denote that the world is moving toward freer trade, less restricted by tariff barriers.

As more markets become international — even global — the American middle-market business must find ways to serve its customers wherever it operates and bar competitors from obtaining footholds, or eventually lose out.

The pace and cost of technological change is accelerating, further increasing consolidation pressures.

When IBM Corp. builds one of its computer models in North America, Europe, and Asia, for example, it wants a single source of power supplies for that model that is able to supply each location cost-effectively and with uniformly high quality.

In an early 1994 presentation on financing middle-market transactions offered just weeks before his death, Robert A. Miller, president of Congress Financial Corp.,

said "The global economy has come to the middle market," meaning that middle-market companies must be prepared to do business around the world, if need be. A wide variety of successful middle-market businesses are adding shareholder value by pursuing joint ventures, co-marketing agreements, technology licenses,

Everyone involved must understand the "vision" behind the transaction and its critical success factors.

and other strategic alliances with carefully chosen businesses in the Americas, Europe, and Asia to gain transnational reach.

Transformation of the Financial Buyer Some of the strongest financial buyers of the 1980s have transformed themselves very effectively since the demise of the financially driven, highly leveraged middle-market transaction that flourished in the era of casual lending. They have become a new type of strategic buyer, thus improving their odds of successful investment and bringing to the table competitive advantage, not just money. Transformed middle-market financial buyers include those that are:

- Finding niche or modest-sized markets where they can be major players. Examples include Wingate Partners' Century Products Co. in juvenile safety products and Harbour Group in injection molding.
- Staying focused and bringing on board industry-specific expertise, such as Ampersand Ventures' investments in specialty materials businesses.
- Using add-ons to core portfolio companies to form strategic groups. Jordan Industries Inc. groups include five specialty advertising businesses, three electric motor manufacturers, and five religious books and bible businesses.

Given the very demanding nature of truly strategic needs, how should managements and acquisition professionals proceed?

Pursuing a financially driven acquisition follows a well-known drill: Avoid fast-changing markets; use discounted cash flow (DCF) analysis on a stand-alone basis; conduct due diligence to ensure that there are no financial surprises; devise incentives for management; and negotiate directorships to monitor performance after closing. Financial expertise and perspective are paramount.

The strategy-driven deal is a different animal. It has greater risks and potential rewards. As a result, the entire planning and execution process must be more rigorous and imbued with fresh thinking. The process requires:

- A more inclusive acquisition approach proxied by opening the process to more skilled people;
- More time and money; and
- Different priorities than in the past.

A More Inclusive Acquisition Team

From the time acquisition criteria are set until the closing celebration strategic acquisitions and alliances require the expertise and perspective of many diverse disciplines in planning and execution.

Within the initiating company, the project team needs the leadership of top management and directors as well as expertise from the operations, marketing, and finance people. At critical stages, engineering, new product development, and human resources personnel also should be involved.

The company's outside advisers should bring understanding and background beyond investment banking, accounting, and legal expertise. Desirable areas of "extended experience" for outside advisers at a minimum include:

- Industry-specific knowledge, with a global perspective;
- Understanding of the initiating company's corporate culture and values;
- Familiarity with any critical technologies and their business ramifications; and
- Country-specific knowledge and reliable local contacts to assist in international expansions.

Outside advisers need to relate to all disciplines on the team and be effective team players. The super egos that made "Barbarians at the Gate" so entertaining cannot be tolerated on the strategic, value-minded team of the 1990s.

Everyone involved, insider and consultant alike, must understand the "vision" behind the transaction and its critical success factors. The inevitable debate over specific acquisition criteria and their priority is healthy. The acquisition advisers as well as the corporate team need to be part of it.

This more inclusive approach also may include technical specialists brought in for limited advice on esoteric issues, e.g., the poultry producer that hires a feed-grinding equipment engineer to determine whether changes to the equipment can speed weight gain in chickens, and therefore increase profitability.

More Time and Money for the Acquisition Process

The extended acquisition team is only one reason why strategic acquisitions take longer and cost more. More importantly, each strategy-driven task has extra elements that require fresh thought and great care. That is because there are only a few possible transactions (a given candidate: fair price and terms) that will allow the strategic initiative to succeed. Examples of extra work within the familiar acquisition process are:

- Acquisition criteria will include vital nonfinancial issues, e.g., intellectual property, such as patents and trade names; type, age, capabilities, and condition of equipment; the range of value-add services that can be offered by the combined company; composition of the customer base; and channels of distribution.
- Search techniques must go well beyond computer-accessible parameters to include contacts with a host of trade sources and telephone conversations with the candidate, industry experts, and customers. To be successful, these procedures require significant investment of time and thought by a creative, experienced, and tactful person with a clear understanding of the business objectives for the transaction.
- Planning the first approach to the candidate includes being able to clearly explain any non-price reasons for "forming a strategic association," e.g., better growth opportunities for key employees, additional resources to develop new products, access to a new customer group, etc. It also means having answers to questions that will be on the target owner's mind, e.g., "What will the new reporting relationships be?" and "Will our name survive?"
- Due diligence and valuation should take a hard-headed and pragmatic view toward achieving possible synergies, a set of dimensions that is not important in the orthodox financial transaction. The focus is on attainable business benefits (i.e., synergies) and any deal breakers. Due diligence is where the rubber meets the road, where the ideas take on physical dimensions.
- Planning for post-closing integration is a more critical, pervasive task. Harmonizing corporate cultures, employee policies, benefits, product design philosophies, and information systems must receive careful attention.

Changing Priorities in the Acquisition Process

Current strategic deals usually involve confidential negotiations with one or a few qualified parties, rather than sales via "auctions." Most of these acquired companies "never were for sale." So, the initiating entity (buyer or seller) must move with purpose, insight, and discretion to gain and keep an advantage over other would-be acquirers or alliance partners.

When imagining how two businesses could be brought together and how valuable the combination would be, focus on attainable benefits. Questions to keep raising throughout the process include:

- Why are we pursuing this deal?
- What is critical to success and what isn't?
- What is attainable?

The critical success factors must receive attention as early as possible. Set aside due diligence checklists for later. For example, if the initiator is seeking new distribution channels for its products, it should address how good the candidate's sales and marketing groups are and whether they are strong in the intended distribution channels. Or, if the buyer wants to gain a particular technology, it should focus on the candidate's technological strengths and weaknesses and the quality of its people, perhaps using an outside expert to provide guidance on emerging competitive technologies.

Cost savings must be based on a realistic post-closing operating plan that management is committed to implement.

Traditional due diligence emphasized financial statement matters, e.g., Are receivables collectible? Is inventory saleable? Are there any unrecorded liabilities? Can costs and expenses be cut? The strategic element of due diligence is less routinized and harder to quantify. Assuming that there will be additional sales simply because of "synergy" always deserves a careful look. If the acquiring company is selling housewares to mass merchandisers and the target makes yard and garden products, it isn't a complete match. Different purchasing agents at Wal-Mart and other chains may act like different customers. Cross-selling would be more difficult if a salesman must sell a new product brought in by acquisition to an agent that he or she does not know.

Cost savings, if any, must be based on a realistic post-closing operating plan that management is committed to implement. For example, an acquirer should not count on reducing inventory levels if the primary reason that customers buy from the target — and perhaps pay a premium — is because, "they always deliver within 24 hours."

Financial forecasts must be prepared, and the devil is

in the assumptions. Nothing new there but the complexities have increased. That is why experts in operations, marketing, finance, information systems, and human resources must be enlisted to grapple with the basic question, "What would be attainable if we put these businesses together?" Many combining companies typically have found that benefits take longer to attain than initially expected.

With a realistic set of financial forecasts, economic value added (EVA) for the strategic initiative can be computed using modeling software. In practice, this will be done as a series of increasingly refined iterations as better information becomes available.

It is critical to ferret out any deal breakers early in the process. The strategic transaction has its own predictable set of possible deal breakers in addition to the best-known snags—price, representations and warranties, and the perennially scary environmental cleanups. These may include:

- Irreconcilable corporate values between the companies;
- Incompatible compensation philosophies;
- Disappointing "deal drivers" — a primary example being when due diligence finds that the target's market share is deteriorating or below original estimates;
- Failure of the proposed transaction to add economic value, i.e., negative EVA results even when based on best operating assumptions; or
- Damage to the acquirer's core business. An example was an international chemicals company that cancelled the divestiture of a local business when it learned that the buyer planned to take the acquired technology to other markets, where it would compete with the seller.

Conventional wisdom is that the strategic buyer will pay more than the financial acquirer. Deal to deal that may not be the case. In the end, the competitive dynamics of the deal may not support a higher price from the strategic buyer. The primary reason is that, based on careful scrutiny, not many candidates are truly strategic. If only a few candidates are attractive enough to be of strong continuing interest to the initiating company, the mirage of a premium deal vanishes for those that can't make the cut.

Furthermore, the best candidates may be unreceptive to discussions because they may be afraid to open up to a suitor that is also a competitor. In truth, the better the fit, the more challenging it is to bring two parties into fruitful discussions.

It is vital to be sensitive to a seller's concerns that employees and customers not learn of the discussions prematurely. It is equally critical that the acquirer use the approach, negotiating, and investigatory techniques that are the least threatening. The idea is to "peel back the onion" very carefully, building trust and saving the most sensitive matters, such as customer lists, until a deal comes into focus.

The better the fit, the more challenging it is to bring two parties into fruitful discussions.

Due to home-market recessions, European and Japanese companies, which historically have paid higher prices for strategic acquisitions, have shown little vigor as acquirers over the past several years, thereby decreasing competition for attractive targets.

Timing can always be a wild card in finding the best candidate. We offered a business for sale to a number of aluminum extruders just as that industry was collapsing. We finally sold the business to a financial buyer. But today's middle market shows signs of better balance between buyers' and sellers' needs. Business confidence is also more widespread, as is ample financing for attractive deals.

Given the healthy state of the 1990s middle market, win-win transactions are being closed. If the transaction is skillfully handled, the combined entity should be a stronger, more effective competitor and its shareholders should reap added economic value from their investments. ■

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WHARTON REPROGRAPHICS

M&A

Pricing

Valuing the Glamour In Brand Name Acquisitions

Michael J. Martin

Sales were the dominant elements in determining the lofty prices paid for consumer goods companies during the 1980s, according to a study. The findings suggest that sales were used by acquirers as a proxy for the otherwise unquantifiable allure of brand names and franchises.

THE BOOM IN ACQUISITIONS of consumer packaged goods companies during the late 1980s was punctuated by spirited bidding and fancy purchase prices. What did the buyers really pay for? Statistically, the answer seems to be "the target's sales." But the strategic rationale goes deeper than that. Evidence suggests that sales actually served as the quantitative proxies for the values of brand recognition, consumer franchises, and related intangible assets that typically were the primary attractions of the targets.

These conclusions were drawn from a study of 66 acquisitions of domestic consumer packaged goods manufacturers between 1984 and 1989 and the generation of trend data through computer-based regression analyses. The most striking result was that the magnitude of the target's sales consistently emerged in the calculations as the primary determinant of the purchase price. Volume enjoyed a much more significant statistical correlation with the price than such other recognized influences as operating income, net income, and book value.. Moreover, there was little or no correlation between the price and external, or m&a market-based, bench marks, such as price tags for comparable companies and premiums over stock prices. This article reviews the basic findings and their possible implications for pricing and valuing of consumer goods acquisitions. It represents an initial exploration of a hotbed of 1980s m&a activity, and, as with many regression analyses, there are evidentiary drawbacks that preclude the assertion of absolute conclusions.

The 66-deal sample is based on acquisitions in which the sales and purchase prices of the targets, mostly stand-alone public companies or units of publicly held firms, were known. Data for other measurements, such as net income and book value, were not as abundant. Moreover, the sample includes targets in five separate markets — over-the-counter (OTC) pharmaceuticals, toiletries, cosmetics, household products, and food. While commonly distinguished by brand names and generally falling under the consumer packaged goods umbrella, these firms easily could be construed as operating in separate arenas with distinct characteristics and acquisition strategies.

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Parameters of the Markets

Definitions of market classifications in the branded consumer goods industry for purposes of the study include:

Over-the-Counter Drug Companies — Makers of therapeutic products strictly governed by the Food & Drug Administration, including antacids, analgesics, diuretics, mouthwashes, and vitamins, that essentially are sold without a prescription and are designed for human consumption.

Toiletries — Producers of health and beauty aids that largely are used for external purposes, including skin care products, deodorants, soaps, and toothpastes. They are sold in mass-marketed outlets and are popular-priced.

Cosmetics — Makers of products that are similar to toiletries but tend to be more fragrance- and skin care-oriented. The distinguishable feature is that this class of products tends to be sold in department stores and upscale drug stores. The price point tends to be higher than on toiletries.

Household Products/Other — Manufacturers of products for cleaning, home repair, and similar purposes, including such disposable products as batteries. They are sold through mass-market outlets and, in some cases, through specialty outlets, such as hardware stores.

Food — Processors of consumable food products for humans or pets and largely sold through supermarkets and convenience stores.

— Michael J. Martin

Nor can a pure statistical analysis capture such qualitative factors as the individual motivations of the buyers, the availability of targets, the competition for a particular candidate at a given time, or the pricing fluctuations in the general m&a market.

Nevertheless, the consistency of sales volume as a driver of the purchase price merits further analysis. Although the result can lead to many interpretations, it is quite plausible, by overlaying a number of strategic and operating considerations on the findings, to suggest that sales served as a quick substitute for more esoteric determinants of brand and franchise value.

For example, 55 of the 66 acquirers were themselves consumer packaged goods producers or strategic buyers that presumably would understand the value of brands and how acquisitions would extend their existing businesses. Such buyers also enjoyed the greatest opportunities for adding further value through synergies. Brisk demand for well-established consumer goods players often forced bidders into analytical proxies for valuing brands. Speed was further dictated by importance of acquisition in markets characterized by consolidation, globalization, rising product development and marketing costs, and other economic pressures.

Just how were sales identified as the primary determinant in purchase prices?

After assembling all of the data and devising the sample, I developed a multivariate regression equation to capture the key recognizable variables that influence acquisition prices. The basic equation was adjusted depending on the specific forces being examined.

Thus, one principal equation evaluated the relative importance of net sales and net income as factors in determining purchase prices. That equation was:

$PP = bO + b1\ NS + b2\ I + e$

where

PP = Purchase price

bO = a constant

b1 NS = the target's net sales

b2 I = the target's net income

This equation was applied to the 30 deals for which both the sales and net income of the target were known. The results were:

$PP = +36\,(bO) + 0.6\,(NS) + 7.51\,(I) + e$

The standard error on the net sales result was 0.2 and the finding was significant at the 1% level. The R^2 was 91%. R^2 is the coefficient of determination which explains how much of the variability of the purchase price is explained by the net sales and net income of the target company. In this case, about 90% of the purchase price variability was explained by the sales of the target company. Net income was not statistically important.

Additionally, "significant at the 1% level" means that net sales is a statistically important factor in determining the net purchase prices. Conversely, there is only one chance in 100 that the relationship between net sales and purchase price is a random event.

On the basis of that equation, aggregate net sales data essentially explained the preponderance of

the variability of the purchase price. While net income was found to be a positive influence on the purchase price, it was not a statistically significant determinant.

To further test the methodology, I eliminated net income, adapted the equation to incorporate only the sales component, and applied it to all 66 transactions. The results were:

PP = -134 (bO) + 1.2 (NS) + e

The standard error on net sales was 0.2 and the finding was significant at 1%. The R^2 was 82%.

In this case, in which a broader sample was used, more than 80% of the purchase price variability was explained by sales of the target. And significance at the 1% level affirmed the consistency of the relationship between sales and purchase price.

In both cases, the high R^2 result affirmed the importance of sales in determining the purchase price, and the subtraction of the net income variable did not detract from the explanatory power.

Subsequent runs of the equation utilized other factors, including book value of the target, known in 24 cases; operating earnings, available in only 10 cases; lagged acquisition prices for consumer packaged goods companies; and stock prices of comparable companies. None of them had a statistically significant relationship with purchase prices, and only sales was found to have systematically affected prices.

Besides indicating that sales served as surrogates for brand and franchise values, the calculations offered grounds for other tentative conclusions.

On one level, the lesser relevance of net income to purchase price indicated that buyers largely were focusing on future earnings, especially when they could be massaged through synergies. On another level, the result may stem from a sparsity of deals by financial buyers — LBOs accounted for only 11 of the 66 transactions — that presumably put would more weight on income because of debt service requirements.

The lack of relevance for book value is not necessarily surprising since the values of trademarks and similar intangibles usually are not carried on balance sheets or are recorded at unrealistically low values.

The study also went behind the macro data in an effort to identify underlying factors that may have impacted pricing trends for the entire group. Some of the micro data provided useful, correlative infor-

Table 1: Purchase-Price-to-Sales Multiples by Consumer Products Market Classifications — 1984 to 1989

Market Segment	No. of Deals	Average Deal Value ($ mil)	Purchase-Price Multiples Times Sales	Times Net Income
OTC Drugs	11	$298	2.3	19.2
Toiletries	19	520	1.9	25.0
Cosmetics	13	369	1.3	19.1
Household Products/Other	7	419	1.0	32.1
Food	16	4,572	0.9	27.6
Average		*$1,235*	*1.5*	*24.6*

Source: Author's calculations

Table 2: Financial Profile of Consumer Packaged Goods Industry — 1985 to 1989, Includes Estimates for 1990

Market Segment	Average Operating Profit Margins (%)	Sales Growth (%)	Net Income Growth (%)	Multiple of Stock Market Value to Sales
OTC Drugs	24.8	23.0	29.6	2.3
Toiletries/Cosmetics	16.3	13.8	20.2	1.0
Household Products/Other	12.8	13.1	20.6	0.8
Food	10.8	16.2	19.5	0.6

Source: Value Line Investment Surveys

Table 3: Purchase-Price-to-Sales Multiples Annual Average for All Consumer Products Acquisitions — 1984 to 1989

Year	No. of Deals	Purchase-Price Multiple Times Sales
1984	9	0.7
1985	10	1.3
1986	6	1.1
1987	14	1.5
1988	12	2.2
1989	15	1.7
Average		*1.4*

Source: Author's calculations

Table 4: Purchase-Price-to-Sales Multiples in Consumer Products Acquisitions by Deal Value — 1984 to 1989

Deal Value	No. of Deals	Purchase-Price Multiple Times Sales
More than $1 billion	14	1.4
$300 million to $1 billion	15	1.9
$100 million to $299 million	23	1.2
Less than $100 million	14	1.6
Average		*1.5*

Source: Author's calculations

mation. Other findings are open to debate. But all are interesting.

For example, the study found sharp distinctions in values among the five categories of consumer goods companies when measured by the multiple of price to sales (See Table 1 on page 33).

On this narrow basis, OTC pharmaceuticals companies were the highest-valued targets, commanding purchase prices, on average, of 2.3 times sales. Interestingly, OTC drug firms were involved, again on average, in the lowest-priced deals of the entire consumer products group. Conversely, food companies, targets of the highest-priced deals, on average drew the lowest multiples of sales — 0.9.

There were some intriguing interplays within the averages. Although most deals in OTC drugs were of small-to-modest size, the group included one megadeal — Procter & Gamble Co.'s $1.6 billion acquisition of Richardson-Vicks Inc. in 1985. The deal was executed at 1.2 times sales, or the lowest of the 11 OTC deals. That may have been attributable to P&G's role as a white-knight buyer.

The most generous OTC drug multiples were in smaller deals that landed highly visible or hot-selling brands. Leading the pack was the 1989 purchase of the ICI Americas Inc.'s OTC business, which includes the Mylanta antacid, by the Johnson & Johnson-Merck & Co. Consumer Pharmaceutical Co. joint venture. The $450 million deal value was 3.6 times sales. The next highest multiple, 2.9 times sales, was in Ciba-Geigy Corp.'s 1987 purchase of the Doan's Pills brand from DEP Inc. for $35 million, the lowest-priced deal in the OTC group. The upper end also included P&G's 1985 acquisition of G.D. Searle & Co.'s OTC business for $310 million, or 2.8 times sales; Beecham Group PLC's acquisition of Norcliff Thayer (Tums, Oxy anti-acne products) from Revlon Inc. in 1985 for $360 million, or 2.7 times sales; and Pfizer Inc.'s 1988 acquisition of Oral Research Laboratories Inc. (Plax tooth rinse) for $200 million, or 2.7 times sales.

Ironically, the price/sales multiple for OTC drug companies rises to 2.5 if two acquisitions of vitamin producers by Japanese companies, both done at 1.2 times sales, are excluded. They are the Yamanouchi Pharmaceutical Co. Ltd.'s acquisition of Shaklee Corp. in 1989 for $724 million and Otsuka Pharmaceutical Co. Ltd.'s purchase of privately owned Pharmavite Corp. in 1989 for $60 million. The vitamin deals tended to be done at less robust valuations relative to sales because of low barriers to entry and light consumer brand loyalty.

The high average purchase price for 16 deals in the food industry reflects the inclusion of seven jumbo-sized acquisitions priced at $2.5 billion and over. The largest transactions were the LBO of RJR Nabisco Inc. in 1989, with a straight purchase price of $24.7 billion, and Philip Morris Cos. Inc.'s acquisition of Kraft Inc. the year before for $12.6 billion.

On a fully loaded basis, including merger and financing expenses, the total cost of the RJR deal was nearly $29 billion. If the total cost is used as a bench mark, RJR drew the top price-to-sales multiple, 1.7. But the variations, that resulted in a negative premium to sales for the entire group, were largely functions of timing. The multiples generally swung from negative to positive as the five-year time frame proceeded. Ralston Purina Co.'s $475 million purchase of Continental Baking Co. from ITT Corp. in 1984 represented a multiple of only 0.3, and multiples on much larger deals that year were well below one times sales. The multiple was only 0.4 for Beatrice Cos. Inc.'s $2.7 billion acquisition of Esmark Inc., and only 0.8 on Nestlé SA's $2.9 billion acquisi-

tion of Carnation Co. in 1985. Multiples also were less than one times sales on Philip Morris' $5.6 acquisition of General Foods Corp. in 1985 and for the 1986 Beatrice LBO, based on a total value of more than $8 billion, including financing and other costs.

But multiples above one were common by 1988 and 1989 — 1.2 times sales in the Philip Morris-Kraft deal and 1.1 times sales in the hostile acquisition of Pillsbury Co. by Grand Metropolitan PLC of the U.K. for $6.5 billion.

The heftiest multiple in the toiletries area was 3.7 times sales in the 1988 acquisition of privately owned John O. Butler Co. (Butler dental products) by Sunstar Inc. of japan for $161 million. In the biggest deal, Unilever PLC's 1987 acquisition of Chesebrough-Pond's Inc. for $3.1 billion, the multiple was 1.1.

In cosmetics, the largest multiple, 4.9 times sales, was paid by Shiseido Co. Ltd. of Japan to acquire Zotos International Inc. in 1988 for $345 million. That also was the highest multiple for any deal of the 66 deals in the sample. The MacAndrews & Forbes Holdings Inc. hostile acquisition of Revlon for $1.7 billion in 1985 was the biggest deal in the cosmetics group and also the transaction with the lowest price-to-sales multiple, 0.7.

Household and other products included just one large deal, the Kohlberg Kravis Roberts & Co. buyout of the Duracell battery-making division of Kraft in 1988 for $1.8 billion following a spirited auction. That also represented the highest multiple in the group — 1.8 times sales.

The multiples in cosmetics, toiletries, and household products virtually tracked those in the food industry, advancing from negative ground early in the span to premium levels by 1989. That upturn mirrors the increasing degrees of competition in the m&a market and its resultant tendency to pay larger premiums for the narrowing group of attractive candidates that were still available after major acquisitions.

Acquisition values, again relative to sales, also seemed to run lockstep with the growth trends and the profit margins in specific markets (See Table 2 on page 33). Here we run into a data-gathering problem. The figures for the pharmaceutical industry combine performances of OTC firms with ethical manufacturers, which generally have higher

Table 5: Acquisitions of Consumer Products Companies by Japanese Buyers — 1984 to 1989

Buyer	Target	Value ($ mil)	Purchase-Price Multiple Times Sales	Average Multiple of Sales for Market Group+	Market Segment	Year
Yamanouchi Pharmaceutical Co. Ltd.	Shaklee Corp.	$724	1.2	2.5	OTC drugs	1989
Shiseido Co. Ltd.	Zotos International Inc.	345	4.9	1.2	Cosmetics	1988
KAO Corp.	Andrew Jergens Co. unit of American Brands Inc.	300	1.7	2.4	Toiletries	1988
Sunstar Inc.	John O. Butler Co.	161	3.7	2.4	Toiletries	1988
Nippon Sanso KK	Thermos Co. unit of Household International Inc.	134	0.7	1.0	Household products	1989
Rohto Pharmaceutical Co.	Mentholatum Co.	93	1.3	2.0	OTC drugs	1988
Tsumura & Co.	Medical and fragrance units of Minnetonka Corp.	67	0.9	1.2	Cosmetics	1989
Otsuka Pharmaceutical Co. Ltd.	Pharmavite Corp.	60	1.2	2.1	OTC drugs	1989
Average		235	2.0			

+Average purchase-price-to-sales multiple for relevant industry group in the year of the deal. In 1988, there were no comparable cosmetic transactions.
Source: M&A Data Base, ADP/MLR

Table 6: The Priciest...
Consumer Products Acquisitions With the Highest Price-to-Sales Multiples — 1984 to 1989

Buyer	Target	Market Segment	Value ($ mil)	Price-to-Sales Multiple	Year
Shiseido Co. Ltd.	Zotos International Inc.	Cosmetics	$345	4.9	1988
Sunstar Inc.	John O. Butler Co.	Toiletries	161	3.7	1988
Johnson & Johnson-Merck & Co Consumer Pharmaceutical Co.	Proprietary drugs unit of ICI Americas Inc.	OTC drugs	450	3.6	1989*
Procter & Gamble Co.	Bain de Soleil brand of Revlon Inc.	Toiletries	70	3.0	1987
Ciba-Geigy Inc.	Doan's Pills brand of DEP Inc.	OTC drugs	35	2.9	1987
Procter & Gamble Co.	Proprietary drugs unit of G.D. Searle & Co.	OTC drugs	310	2.8	1985
Beecham Group PLC	Norcliff Thayer unit of Revlon Inc.	OTC drugs	360	2.7	1985
Pfizer Inc.	Oral Research Laboratories Inc.	OTC drugs	200	2.7	1988
Bristol-Myers Co.	Mineral Ice brand of Biopractic Group	OTC drugs	37	2.6	1989
Colgate-Palmolive Co.	Vipont Pharmaceutical Inc.	OTC drugs	88	2.6	1989*

And the Bargains...
Consumer Products Acquisitions With the Lowest Price-to-Sales Multiples — 1984 to 1989

Buyer	Target	Market Segment	Value ($ mil)	Price-to-Sales Multiple	Year
Ralston Purina Co.	Continental Baking Co. unit of ITT Corp.	Food	$475	0.3	1984
Beatrice Cos. Inc.	Esmark Inc.	Food	2,710	0.4	1984
Quaker Oats Co.	Anderson, Clayton & Co.	Food	806	0.4	1986
Chesapeake Financial Corp.	Royal Crown Cos.	Food	241	0.5	1984
Philip Morris Cos. Inc.	General Foods Corp.	Food	5,628	0.6	1985
Greyhound Corp.	Purex Industries Inc.	Household products	282	0.6	1985
Anderson, Clayton & Co.	Gaines unit of General Foods Corp.	Pet food	187	0.6	1984
Kohlberg Kravis Roberts & Co.	Beatrice Cos.	Food	8,981**	0.7	1986
MacAnrews & Forbes Holdings Inc.	Revlon Inc.	Cosmetics	1,741	0.7	1985
Nippon Sanso KK	Thermos Co. unit of Household International Inc.	Household products	134	0.7	1989

*Completed in 1990
**Includes merger and financing costs
Source: Author's calculations

profit margins, swifter sales and earnings growth, and larger market capitalizations. And the data for toiletries and cosmetics treat them as a composite market.

However, even with these caveats, the pattern appears to replicate the relative market segment valuations demonstrated by the price-to-sales multiples. Drug companies generated the highest margins and posted the highest sales and earnings growth rates in the 1985-to-1989 period. Again, food was at the bottom of all rankings, except for growth rate in sales.

This suggests that quality of sales apparently have shared power with gross sales as a driver of acquisition pricing and values. In other words, the acquirers appeared to be placing considerable weight on what the sales would bring to the bottom line and what growth prospects were being purchased. Conversely, the low premiums in foods and household products apparently stem from the thin margins posted by companies selling through supermarkets and other mass merchandisers.

Strategic developments in the pharmaceutical industry also are factors in enhancing the appeal of OTC drug companies, notably the increased competition between prescription drug firms and makers of generic drugs. Ethical firms have responded by developing consumer brand variations for more of their prescription products and taking them into the proprietary markets. Acquisitions of OTC firms can provide the distribution channels and marketing skills to augment in-house product developments. The acquisition of Mylanta by the Johnson & Johnson-Merck JV is an example of this trend.

Marketing and distribution strengths also are important in handling the evolving trends in cosmetics and toiletries. For example, upscale fragrances, once the exclusive domain of tony department stores, now are sold increasingly through mass merchandisers. Distribution access to these outlets has been a key goal of acquisitions in both consumer goods segments.

As noted earlier, purchase-price premiums over sales increased virtually year to year during the late 1980s in foods, cosmetics, toiletries, and household products. This had the effect of raising average premiums for the entire consumer products group as the period progressed (See Table 3 on page 34). Note that although the group's multiple declined in 1989 to 1.7 from a peak of 2.2 the year before, it still was well above the levels of the beginning of the span.

As suggested in the earlier analysis of market breakdowns, there appeared to be no correlation between premiums and deal sizes. This was affirmed generally by another test in which I broke out the sample by deal value and calculated the price-to-sales ratio for each group (See Table 4 on page 34). Two possibly relevant observations are that most of the higher-valued OTC drug deals fell into the $300 million-to-$1 billion category, which posted the highest multiple, while 11 of the 23 deals in the $100 million-to-$299 million category, which had the lowest multiple, were food and household product transactions.

Japanese buyers are cautious

Finally, there was some examination of the pricing influence of foreign buyers, a group that included such megadeal makers as Grand Metropolitan, Nestlé, and Unilever. I chose to focus on Japanese buyers because of their relative inexperience in acquisitions and a belief that they are willing to overpay in acquisitions, especially to obtain consumer goods franchises in the U.S. Indeed, it was previously pointed out that a Japanese firm, Shiseido, paid the richest multiple of all for a consumer goods acquisition and that another, Sunstar, led the toiletries segment.

Table 5 (on page 35), which lists the eight deals by Japanese buyers, indicates that those premiums were aberrations. In the other six cases, the Japanese acquirers actually paid lower price-to-sales multiples than the averages for the respective market segments.

Since the study was concluded, virtually all bench marks of m&a pricing have declined and the economy has softened. How this will impact the key quantitative finding of the study — that sales were the key determinants of purchase prices for consumer goods companies — is open to question, since new factors have been introduced into the m&a market.

Certainly, the strategic forces that drove consumer products acquisitions in the 1980s have not faded and, in many cases, have intensified. That suggests that over the longer run acquisition activity and pricing should remain strong. But there could be a temporary pullback as companies focus more intensively on internal development and acquisition alternatives, such as joint ventures, and as licensing becomes more popular. It will be interesting to see whether the new forces assert themselves on pricing during this transition period. ■

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WHARTON REPROGRAPHICS

Touching All Bases In Setting Merger Prices

Brian H. Saffer

Acquirers risk serious error by sticking with a single pet valuation theory to fix an offering price. The most realistic approach is to blend all recognized techniques and influences in the organic valuation cycle.

MOST OF THE LITERATURE on the valuation of companies as acquisition candidates tends to focus on a single approach that is presented by the individual commentator as the true method for evaluating acquisitions. In most cases, it seems, some highly quantitative approach is identified as the correct route to the right answer. Experience, however, has shown that no single method of evaluating companies is entirely correct or truly comprehensive. This is because the acquisition process occurs in the real world where many forces interact, rather than in the classroom or laboratory where surrounding circumstances can be controlled.

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Most of the quantitative approaches are derivatives of discounted cash flow (DCF) analysis, which calculates the value of the cash flow (or profits) to be derived from the ownership of a business entity. In most cases, these formulae have been created by people with highly quantitative (if not academic) backgrounds and have been based upon the indisputably true thesis that anything is worth what it can earn. While economically correct, DCF exists in an environment where it shares significance with other major economic forces that are at work. Regardless of economic decisions made by the analysts using DCF, the real world — the actual market — may be using other standards for evaluating the investment.

In addition to DCF, there are three other principal forms of analysis that are being made in the marketplace to value acquisition candidates: liquidation value, stock market values, and merger market values. While DCF may be indisputably correct from a purely analytical standpoint, the real world intrudes into these other forms of analysis which, when their results differ from the conclusions of DCF, are impossible to ignore. To deny the existence of other forces or other avenues of analysis is to overlook potential sources of value or potential indicators of increased outside risks that should be considered in

the total analytical process. (For descriptions of actual cases where valuation techniques and various influential forces interlocked, see the accompanying sidebar.)

Uniting the three approaches

Since each of the major recognized valuation approaches has merit in that it generates useful information for buyer and seller, none should be discarded. But unless there is a compelling reason for relying on just one technique in a specific m&a transaction, none, conversely, should be considered the pervasive source of all valuation knowledge. Rather, the three major approaches should be regarded as means toward an end, as components of a broadly comprehensive analysis that blends all relevant influences in determining value. The threshold at which the other approaches converge is the organic valuation cycle. But before discussing the organic valuation process, it is necessary to examine the major valuation approaches and identify their functions as subsections of organic valuation.

The benchmark, or lowest value, for any concern is what its assets can be sold for in an orderly way. In liquidating the company, the assets are sold individually for the best obtainable prices, and the liabilities are paid in an orderly fashion. What remains is liquidating value, which may be more or less than book value. Since DCF does not contemplate the value of sales of assets, but focuses instead on cash flows, DCF analysis provides no real indication of liquidation value. Liquidation analysis is usually the domain of appraisers or actuaries.

The stock price theory hangs on the concept that in the case of publicly held companies the stock market continuously is evaluating each concern and expressing that evaluation in the bids and offers for the company's shares. This derives from the belief that all available information may be studied by analysts and investors and that their bids and offers impound this information in a cash price. While conceptually elegant, there is a fatal flaw in this theory. In the stock market, investors are not buying companies; they are buying small and liquid minority investments in companies. Because the investment is liquid, the investor who buys a stock because he believes it is going up (or shorts it because he believes it is going down) is able to capitalize on his correct decision, or cut his losses on his incorrect move, by closing out his position. He has no control over the workings of the company and seeks to gain from market forces, not management forces.

The buyer of an entire company does not enjoy great liquidity but, indeed, can dictate the future operations of the company, including liquidation. Because of this distinction, the stock investor is not evaluating the fruits of control, and this is why a company can sell for a low price in the stock market until it is cornered by potential acquirers at hefty premiums. It is important to remember that a premium price does not necessarily mean a premium over real value. Rather, the premium may be that percentage over the stock market price that is necessary to draw stock in sufficient quantities to achieve control. In this case the price that includes a premium may very well be less than the real value of the company. Premium also may be expressed as the price paid over book value. However, accounting conventions make book value an unreliable indicator of the value of a company.

Ear to the merger market

The remaining indicator of value is determined by merger-market prices. These are the prices in an array of reasonably similar transactions that are compared to the company in question to determine its relative worth. In theory, the merger market is the true reflection of the market interaction of willing buyers and willing sellers. However, in practice this is rarely the case. The merger market very often reflects aberrations where distress situations have caused target companies to sell too low, or where faddish buyer interests have induced acquiring companies to pay too dearly. Also, it is usually not possible to get truly comparable transactions in most industries because there have not been enough transactions to assure that the deals that have been completed are not reflecting special or extraordinary conditions.

All of these various considerations lead us into a cyclical approach to valuation. In truth, the target company in question, its peers, and the market in general are parts of a larger organism that reflects responses to a wide variety of stimuli. For this reason, the analysis of an individual acquisition target, or even a group of alternative targets, must be viewed in this cyclical, looping, organic manner to be sure that an analyst or evaluator is not being misled.

For example, one could do a discounted flow analysis of a company based upon a forecast that is, in itself, credible. But does this mean that the buyer automatically is willing to pay the price that emerges in the DCF forecast? The answer is: not

necessarily. For instance, if the DCF value is twice the value that the company's stock is selling for, is it sound business judgment to offer double the stock price, at least for openers? Of course, if there have been 12 other similar transactions at the calculated DCF prices, one would reasonably believe that a seller would be reluctant to sell for less than that going rate. However, if there have been no market transactions at these high prices, there is no reason to open negotiations at two times stock market price.

If our hypothetical price of two times market value equates with liquidation value, we have a considerably different scenario. It would be reasonable to assume that a seller would not willingly sell for less than liquidating value (unless he was susceptible to a tender offer). In this case, when DCF corresponds with liquidation, a low market would probably not deter the acquirer. If the situation is reversed, and DCF and liquidating value are below merger or stock market value, this is clearly a situation in which the buyer's neck is on the block and in a great risk of having the ax fall. If merger-market and stock market prices far exceed DCF and liquidating values, this is clearly symptomatic of a very speculative period in the stock market. In this type of situation a buyer might very well be tempted to sit on the side-

Mega-Mergers Are Too Big for One Technique

A primary example of where alternative valuation approaches overlapped and converged was the sequential acquisitions involving Norton Simon Inc., Esmark Inc., and Beatrice Cos. In 1983, Norton Simon management believed that the worth of the foods and consumer products company approximated its asset values and proposed a $725 million leveraged buyout. But the management was topped by Esmark, also a food and consumer products concern, which acquired Norton Simon for $990 million. Esmark relied on DCF analysis to conclude that Norton Simon was worth more on a DCF basis than it was to the management group. This is not an unusual clash of perspectives. While ownership of Norton Simon would change in the LBO, it would remain an independent, stand-alone entity and its value to the buying management rested largely in what the assets were worth. Esmark, on the other hand, saw many synergies in combining the two firms and the opportunity to convert the fit into increased shareholder value.

Approximately a year later, Esmark was in the target role under remarkably similar circumstances. Initially, it was the centerpiece of a proposed $2.3 billion LBO, only to have Beatrice, still another food and consumer products company, step in with a successful $2.7 billion offer. Beatrice reasoned that it could gain more value from Esmark's properties, in part through application of synergies, than the market believed Esmark was worth on its own. The sequence had a medium-sized fish swallowing a minnow and a whale subsequently swallowing the fish — with each buyer hypothesizing a different form of acquisition analysis.

A different example of how valuation methods converged was in two giant oil company acquisitions — Du Pont Co.'s absorption of Conoco Inc. in 1981 for $7.9 billion, and U.S. Steel Corp.'s acquisition of Marathon Oil Co. the following year for nearly $6.2 billion. The winning bidders had to beat back spirited competition, including Mobil Corp. in both cases. The bidders were computing the liquidating values of the oil company targets, and the contender with the sharpest pencil, or the most optimistic forecast, became the winner by translating its optimism into the highest price. While the emphasis was on liquidating values, in actuality, liquidating value of an oil company is much more akin to DCF because full value is received only when the oil is extracted from the ground and this process continues over a period of years. However, the tender offer competitions turned into "wars of the green sheets," or in modern bookkeeping parlance, "wars of the computer terminals," to determine who, in effect, would use the most optimistic assumptions to justify the highest prices. There also was a synergistic element in both cases, since Du Pont and U.S. Steel believed they could use some of the assets of the target companies to supply their basic businesses.

B. H. Saffer

Development of Negotiating Strategies

Strategies based on relative risks determined by comparing liquidation, market, and discounted cash flow (DCF) analyses:

Scenario	Relative Risk	Probable Strategy
Market and DCF both below liquidation value	Low	Stress market and/or DCF
Market above both DCF and liquidation (with liquidation at lowest level)	High	Stress DCF; use liquidation to support main strategy
DCF above both market and liquidation (with liquidation at lowest level)	Medium	Stress market; use liquidation to support main strategy
DCF and liquidation above market	Low	Stress market
DCF and market above liquidation (with DCF at highest level)	Medium to high	Stress market

lines and wait to see what happens. But he may not be able to afford this luxury if all of the candidates are being snapped up by competitors.

Tailoring the offer price

The accompanying table shows how the results of various alternative valuation approaches may be correlated to assess acquisition risks and strategies. These types of analyses may be called "if/then" analyses in that they are aimed at deriving conclusions on the basis of generally known conditions. Such a conclusion might be phrased as: "If the market is below liquidation, then my risks of buying at merger market are minimal. But if the opposite is true, then my neck is out a mile." There is nothing magic or even new in "if/thens." Rather, they reflect an intuitive process that goes on among most acquirers examining a potential deal, and suggest that even while not pursuing all avenues in a completely scientific manner, the canny buyer will plug a diversity of influences into the valuation process. It is unlikely that a buyer will be so slavishly devoted to a computer model that he will be willing to pay four times stock market, six times book and twice merger market without once thinking that the computer model was not the sole measure of value.

Even if they don't acknowledge stock and merger market as true analytical forms, few analysts are blind to target company stock prices, and most are aware of relevant transactions in the same industry. Liquidating value often is not a major factor in evaluating a going business but can be a major factor in evaluating a business for sale or a specific troubled company selling at a depressed price.

In a leveraged buyout, asset protection and cash flow coverage of debt service are the key determinants. The entrepreneurs have so little equity invested that as long as the company prospers they are going to make excellent returns on their money. The ones who often lose sight of the rate of return in a leveraged buyout are those who supply some of the debt, especially the mezzanine money providers, who are essentially making equity investments if the transactions sour, but are usually only getting modest returns above debt market rates for assuming the risk. However, leveraged buyouts are more or less a subject unto themselves, being the preserve of individual investors and not corporate acquirers. Parenthetically, the corporate acquirer, when acting as divestor, might ask himself how a company could be a "dog" for him and "star" for somebody else.

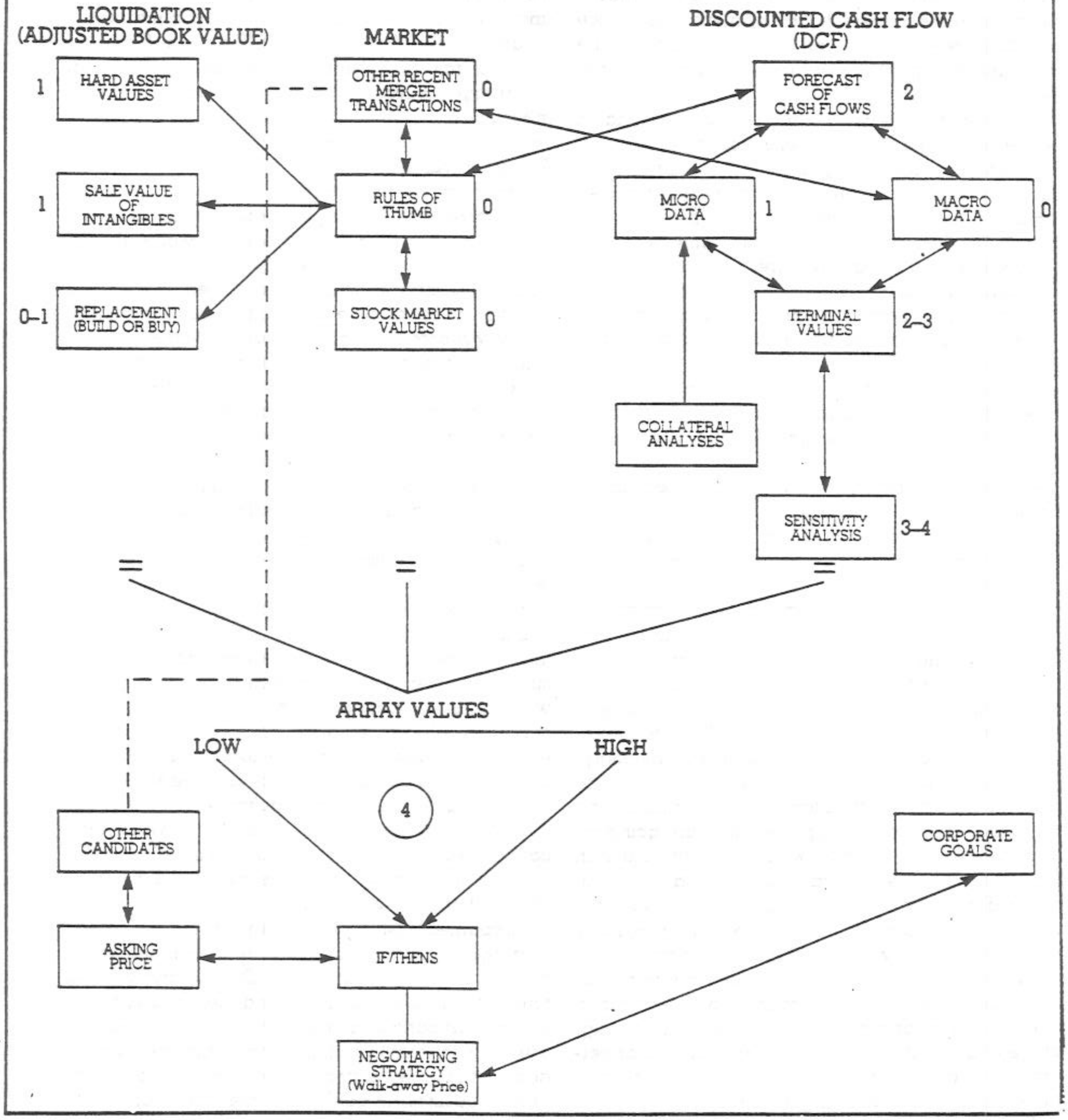
All influences considered

The foregoing points out myriad conflicts in the results obtained from the narrowly focused valuation techniques and suggests that the information extracted from each is necessarily incomplete. Thus, the truly thorough analysis not only will incorporate all relevant factors — theoretical, statistical, psychological, and practical — but, through the organic process, assign appropriate weight and attention to the approaches utilized to generate the data. There is no point in relying on a highly sophisticated computer model for extensive DCF analysis and then spending literally seconds with the latest *Wall Street Journal* for stock market or merger-market analyses. One deserves as much attention as the other. The well-equipped acquirer should be ready to perform stock market, merger-market, and liquidation analyses, as well as DCF, at any time.

If a buyer is following a strategic plan in an acquisition program, it is not necessary to have information on the entire world. Rather, readily available macroeconomic information about target industries should be in the buyer's files. In addition, thanks to electronic data bases, it is relatively easy to maintain up-to-the-minute stock market data on target companies and industries, or to retrieve these data quickly. Relevant transactions can be followed day-to-day or regularly retrieved from a variety of data bases (including the M&A Data Base) so that a ready

THE CORPORATE VALUATION CYCLE

This schematic diagram of the organic valuation cycle shows the unfolding of the process. Initially, the acquirer calculates the values of the target company under the liquidation, market, and discounted cash flow (DCF) approaches using the components that are portrayed and in the time sequence denoted by the numbers at the sides of the boxes. In the final stage, these values (and the factors that influenced them) are combined and additional analytical steps are taken to produce array values or the most realistic prices that can be offered the target.



reference is at hand when an opportunity for serious negotiations presents itself.

The entire organic valuation process, demonstrating how all approaches should be looped to produce a complete valuation picture, is shown on the facing page. Each of the major steps is assigned a number — from zero to four — which corresponds to the stage in the prenegotiation analytical sequence at which certain types of information should be available and at which certain forms of analysis can be done.

A step that is assigned a zero should be handled before a specific valuation exercise takes place. It involves the assembling of macroeconomic data that should be in the files at all times and produced through a continuous information-gathering activity, whether an m&a deal is or isn't imminent. The other stages of the sequence are:

1. Gathering and analysis of microeconomic information, such as data on a specific target company;
2. Use of both macro and micro data to produce forecasts;
3. Calculation of terminal values based on the forecasts and the performing of sensitivity analysis to determine how values may change if conditions change;
4. Use of all foregoing results to map negotiation strategy. (Note that the organic valuation process is a blend of all prior steps and occurs at stage 4.)

Data should be on hand

In liquidation analysis, obviously the assets and liabilities of the individual target company are key components. However, to say that one cannot start on liquidation analysis until one knows the target is begging the question. All companies in certain industries have certain kinds of equipment, inventory, and other physical assets. Why run around in the midst of a hurried acquisition analysis trying to find out what left-handed widget benders are going for in the secondhand market when you can do that in advance? Replacement values, new and used, can be used not only for direct liquidation analysis, but also for the build-or-buy analysis which necessarily should accompany all acquisition programs. Build-or-buy is the choice of whether to buy companies or start businesses from the ground up. Presumably, one only buys companies when the cost, the timing, or the availability of machinery, equipment, or personnel indicates that buying is more economical or more feasible than building from scratch.

Accordingly, a zero-to-one timing level is assigned to replacement analysis. Hard-asset values for a specific company can be determined early in the process. In addition, the sale value of the intangibles, be they patents, trademarks, or whatever, can be assessed. In liquidation analysis, intangibles usually do not have very high values because owners seldom liquidate a highly profitable company and, by definition, companies with high intangible values have high market or DCF values. (For purposes of this discussion, the present value of an advantageous lease is not an intangible. It is a tangible value.)

Applying "rules of thumb"

In market value analysis, note that all the steps are denoted at time zero. The necessary data should be in the files before a specific evaluation begins. If you are looking at widget companies, there is no reason not to know everything about the widget industry before talking to the target. Moreover, it is simple to keep track of stock market values and other trends in an industry. These data may be incorporated into "rules of thumb" concerning acquisition values and prices. The rules of thumb, are, almost by definition, market creatures discerned by keeping an ear to the ground or "listening to the tom-toms." Rules of thumb generally are expressed in multiples — such as the prevailing acquisition prices in an industry times earnings, or book, or revenues — or in unit values, such as the price per barrel of reserves for an oil company or the price per bed for a health-care concern. Significantly, rules of thumb come very early in the evaluation process, suggesting they should not be considered the gospel when finally coming down to the bid-and-ask stage of pricing. All competitors in an industry seldom are equal. They differ on market shares, cost structure, and myriad other characteristics, and the same generous multiple paid for an industry leader may produce an excessive price for an also-ran. While they cannot be bypassed entirely, rules of thumb must be used in the context of results generated by later stages of organic valuation.

Discounted cash flow analysis has the most steps and the most diverse time relationships (zero through four). Central to any DCF analysis is the forecast of future cash flows and their values to the buying company and its shareholders. The forecasts are derived from a combination of macroeconomic data, which are related to the larger world (an industry, business in general, or the entire economy), and microeconomic data, or specific data on the

individual company. The macro data are affected by market information and by broad economic information and forecasts and should be in the negotiator's file before serious discussions begin. Micro data can be developed once a target or group of targets has been pinpointed. After the two sets of data have interacted to create forecasts, the results and the supporting evidence are advanced to step two, where the analyst delineates the terminal values to be accorded the forecast numbers. Collateral analyses have no time value since they are supplementary adjuncts to the mainstream DCF evaluations. Collateral analyses cover the interaction of liquidation value and market value with microeconomic data and nonfinancial data, such as the products of the business audit and human resources review of a specific company.

Scenarios can be varied

Sensitivity analysis, in time periods three to four, is a subject given a great deal of mysticism, particularly since it is often combined with "Monte Carlo"-like probability simulations. Sensitivity analysis is nothing more than trying out several plausible scenarios to find out how sensitive your evaluation is to changes in the input. Since DCF uses the time value of money, it is exceedingly sensitive to the timing of cash inflows and outflows. Also, the implicit compounding within a DCF analysis creates a curve that accelerates the benefits or costs in the analysis. Sensitivity analysis, therefore, does not merely conclude that "if the forecast is 10 percent lower, we have 10 percent less value," or deliver any results with perfect mathematical symmetry. Each value has to be computed individually.

"Time four" is when we array all of the values that we have generated in liquidation, market, or DCF, from low to high, to see what we've got. At this point, we are performing the types of if/then analyses described above. If we can buy the stock at liquidating value and our DCF is three times that amount, we've got a terrific deal. If DCF is above market and above liquidation, we have to be all the more confident of our numbers. Any analysis is, of course, contingent on the asking price of the seller. If you don't have an asking price, you're going to have to hypothesize one, or get some proxy for the seller's price, such as the going prices in similar deals.

In this entire process of comparing our company valuations, we are looping this information back with the asking price, if known, and with other acquisition candidates, in order to see if we can get better value by dealing with another seller. If we reach a go decision, we then have to formulate a negotiating strategy whereby we presumably offer the seller less than the maximum price we are willing to pay. This price may effectively be based on paying what has been paid in other transactions if that number is lower than our DCF value. On the other hand, we may not wish to offer less than liquidation because the seller may feel that a sincere interest is not evident when a price below liquidation is being offered.

Of course, all of the negotiations and all of the evaluations have to be carried out in the framework of strategic and tactical goals and objectives. Clearly, it will not do any good to pay market price for a company that will achieve a rate of return that is below the corporate objective. That is simply throwing away the company's money. On the other hand, time and effort spent in evaluating acquisition candidates in industries that a buyer is not actually interested in entering likewise may waste corporate resources. A key requirement for all of this analysis, looping, and cycling is a team capable of performing in a timely fashion.

While it is difficult to know exactly why one company purchases another, it is certain that the application of a computer model rarely is done in a vacuum. All of the potential sources of value must be considered in the evaluation process, and no evaluation is complete without all of them.

It seems that DCF has been largely taken over by academia, market analyses by the investment banker, and the liquidation value by the appraisal community. In reality none of these is always the right answer, and only the comparison of one against the next will provide the information necessary for a viable corporate strategy. ■

This is the first of two articles on the organic valuation cycle. In the next issue of Mergers & Acquisitions, *Mark Feldman, of Huggins Financial Services, will discuss "The S.W.A.T. Team Approach to Acquisition Analysis" which will include the assembling of necessary personnel and resources and the application of the organic valuation cycle in acquisition analysis.*

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WHARTON REPROGRAPHICS

A STRATEGIC APPROACH TO ACQUISITIONS

H. William Ebeling, Jr. and Thomas L. Doorley III

Acquisitions can be an effective way to improve the competitive position of a company. However, the acquisitions process must shift emphasis away from financial performance to competitive dynamics and must be part of an overall ongoing strategic planning thrust.

Businesses can expand internally through R&D or externally through acquisitions, mergers, and joint ventures. Whatever path is chosen, it must be based on a carefully articulated, well-planned strategy. If acquisition is the vehicle, it must be a structural component of the strategy. If one firm acquires another and the combined entity's returns cannot be significantly higher than the two separate companies' would have been independently, then the acquisition probably wasn't based on sound strategy. This article explores an approach for making profitable acquisitions. Before doing that, it is useful to describe some of the problems associated with acquisitions.

The Problems With Acquisitions

The history of acquisitions shows that many have been unprofitable investments. This dismal track record raises several interesting questions:

- Why have they been bad investments?
- In light of this, why do so many firms persist in pursuing diversification through acquisition?
- What should be done to make the acquisition process produce profitable investments?

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Most acquisitions are "bad deals" for a simple reason. The market usually pegs stock prices about where they belong, adjusting for future returns and risks. In an acquisition, premiums generally are paid to the stockholders of the company being acquired well above the value dictated by the market. More often than not, the acquisition is not justified because the merged companies simply cannot produce sufficient earnings to justify the price paid.

Factors contributing to this are the "hot tip" mentality and "revolving door" situation that often surround acquisitions. Many acquisitions result from "hot tips" to prospective buyers from investment bankers. At the same time, the acquisition minded are continually scanning financial data looking for "good deals." This combination of "hot tips" and overreliance on only financial screening creates the "revolving door" situation in which one buyer literally follows another into the "hot tip's" office with a bid. No wonder such high premiums are being paid.

Don't blame investment bankers. Their job is mainly to broker deals, not recommend them. Although some are certainly effective in this area, relying solely on investment bankers to *recommend* acquisitions could be like letting a computer salesperson tell you how much and what type of computer equipment to buy or a real estate agent tell you what house to buy. They are likely to tell you to buy the one they're showing you.

Firms still pursue diversification through acquisition in this manner because of their short time horizons and risk aversion. A company with a short time horizon, perhaps seeing its sales growth and earnings slip away, realizes that the fastest way to change its income statement is through an acquisition. Even if the price paid is too high, the short-term boost in sales and earnings for the total company may temporarily appear to justify the acquisition. The long-term effect, however, is to further weaken the company because the continued allocation of substantial capital to poor investments is a losing strategy.

Similarly, risk-averse companies often see the acquisition route as their best diversification vehicle. They prefer more stable but lower returns to potentially higher but riskier ones. Consequently, these companies often prefer acquisitions to internally generated growth through research and development. Also, once a firm loses its ability to deal with uncertainty, it becomes more difficult for it to grow from internal development and innovation. It generally has to resort to acquisition.[1] The types of firms acquired in this instance can tend to be "high flyers" for which high price-to-earnings multiples are paid. Unless the acquiring firm brings something substantive to the marriage and doesn't stifle the innovative spirit of the acquired firm, the investment can turn out to be a very poor one.

Given these problems, it is no wonder there are so many critics of acquisitions. For the vast majority of acquisitions, the company—and certainly society—would have been better off had the capital been employed elsewhere. What is good for business is good for the country only if business is effectively deploying capital.

In theory, the capital only changes hands but continued shuffling of capital to poor acquisitions has a net cost to the country in foregone opportunities, wasted services such as legal, accounting, and investment bankers related to closing the deals, and wasted management time.

What, then, can be done to make the acquisition process more effective?

An Effective Acquisition Process

The essential elements of an effective acquisition process are:

- Stating the firm's strategy.
- Developing acquisition criteria.
- Eliminating inappropriate sectors.
- Screening for promising sectors.
- Selecting promising candidates.

[1] For more on this, see Burton H. Klein, *Dynamic Economics* (1977).

Far more emphasis must be placed on the competitive dynamics in industry sectors of interest and in the underlying ability of a potential candidate to compete effectively in those sectors than on current financial performance as a means to find promising candidates. We will develop these points in the sections that follow.

Stating Strategy

An effective acquisition process flows naturally from a sound strategic planning process. They go hand in hand. The process must be active at both corporate and business unit levels to produce the necessary background for a sound acquisition program. The emphasis must be on setting context for strategy and developing strategic alternatives which may include acquisition, rather than on detailed plans and budgets.

Acquisitions should then be aimed at improving competitive position within a promising industry at less resource cost and with more prospects of excellent financial performance than other alternatives.

Developing Acquisition Criteria

The criteria should include:

- An upper limit on the scale of the acquisition.
- Industries that can't be considered due to the biases of senior management.
- Broad activity/technology/skill base definitions where synergy—the intangible but all important ingredient requisite in married bliss and corporate acquisitions—might be found.

One criterion that definitely should not be included at this point is any current profitability measure for potential candidates. This is the biggest mistake in setting acquisition criteria, since the objective of the process should be to find a candidate that will improve the combined future profitability of the firms enough to justify the price. Good current profitability will often increase the number of potential buyers and, hence, the premiums. It also misses crucial nonfinancial considerations, as will be described below, which outweigh current financial performance in predicting success.

Eliminating Inappropriate Sectors

Using the established criteria, a broad scan of the economy should be made to eliminate unacceptable industries. For example, if a criterion was an upper limit of $100 million in sales for an acquisition candidate, computer mainframe producers or basic mining can probably be eliminated. Or, if due to management bias the

acquisition must be in consumer products, major sectors of the economy can be set aside.

The most important criterion to apply correctly is the one covering synergy with some activity, technology, or skill base. At this stage of the process, this means considering those sectors of the economy where there is even a remote connection to any current business. For example, this could include sectors containing companies making products you don't currently make which could be sold to customers through your existing distribution channels.

Screening for Promising Sectors

Once a broad set of acceptable sectors has been identified, the next objective is to narrow the list of sectors considerably. As suggested, acquisitions should be first aimed at improving the competitive position of the combined entity within a promising industry. Thus, we believe two factors should play the significant role at this stage in the screening of sectors: competitive dynamics and industry trends.

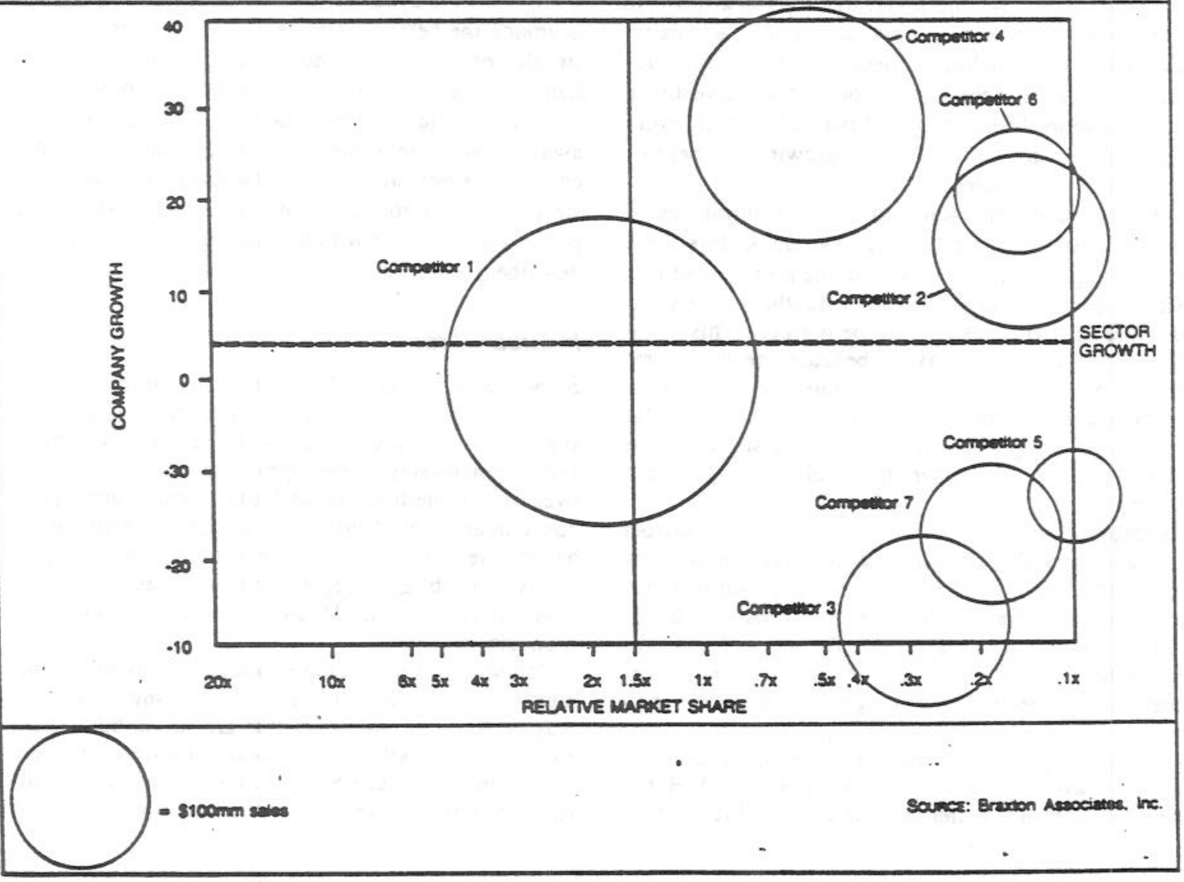
Competitive Dynamics

A key to further filtering the sectors is the competitive dynamics in each sector. In order to understand this concept it is useful to introduce a display we call the "sector graph." (See Exhibit 1.)

On the horizontal axis, we have plotted the relative market share of each competitor participating in the sector under consideration. Relative market share is the ratio of sales of the largest competitor to the next largest, or to the largest for all other competitors. We believe relative market share is a better approximation of competitive position than absolute share.

On the vertical axis, we have plotted the recent growth of each competitor in the sector. The dashed

EXHIBIT 1
Sector Graph



SOURCE: Braxton Associates, Inc.

line is the recent average growth rate of the sector overall. Circle sizes are proportional to each competitor's sales in the sector.

Combining competitive position and growth is a good way to acquire an initial feel for the competitive dynamics in the sectors under consideration. In fact, we would use competitive dynamics as the next filter to further narrow the list of potentially attractive sectors. How, then, would we read these displays in order to find attractive sectors?

Let's start by considering two unattractive sectors from a competitive dynamics standpoint. (See Exhibit 2.) The first sector (business forms) is what we call a "highly consolidated" sector. That is, the leading competitor has a commanding position and is holding share. Unless you could acquire Moore forms, this is not the first sector we would consider for promising candidates.

At this point, those who have read the latest hedges on sound strategy invariably raise the issue of niches. "Maybe one of those other companies is in a very profitable niche," they say. Yes, maybe, indeed. However, effectively searching for acquisition candidates is a costly but not a perfect process and, unless you understand the business forms business extremely well, why waste time and money searching for a niche if other more promising sectors are readily apparent. Also, beware of niches. Unless a niche is truly defensible, today's niche can be tomorrow's divestiture because Moore likely has the basic skills to compete effectively in any profitable, fast-growing segment of the industry that emerges.

The second sector (radio and TV transmitting equipment) is what we call a "strong key competitors" sector. Although still unconsolidated, the lead competitors (Nippon Electric Corporation and Raytheon) are gaining share (growing faster than the market). This is another type of sector to avoid because the lead competitors are very strong and gaining share. Unless combining a position you have with one of the smaller players can bring you within striking distance of the leaders, this type of sector should also generally be a low priority.

Exhibit 3 illustrates examples of the types of sectors that have favorable competitive dynamics. In the first sector, McGraw-Hill (MH) is in the lead position but is slowly losing share. On the other hand, Harcourt Brace (HB) is gaining share fairly rapidly and will overtake MH within a few years, if current trends continue. From this perspective, HB is a good acquisition candidate.

The earnings growth rate shown in parenthesis below the two companies' names show that MH has grown its earnings faster than its sales and faster than HB's earnings. At the same time, HB has grown its earnings slower than its sales.

It is reasonable for HB to sacrifice profitability to gain share, just as it may be for MH to sacrifice share to grow earnings. However, acquisitions should be aimed at improving competitive position to obtain future returns. Therefore, HB on first blush appears to be a better acquisition candidate than MH because its premium is likely to be lower and its competitive dynamics are more favorable.

A caution is in order at this point. One of the tricks is to consider appropriate sectors. As it turns out, there are ways to further segment the publishing sector into more meaningful cuts that reflect truly different and defensible skill bases such as periodicals versus books. However, the essence of the example is still correct.

The objective is to find sectors with companies performing like HB in them. The machine tool sector has them. Note that many competitors are gaining share on Cincinnati Milicron (e.g., Cross and Trecker, Acme-Cleveland, Giddings & Lewis, and a host of Japanese companies). The Japanese are growing faster than the others, so, if an acquisition is made in this sector, an explicit plan for dealing with the Japanese competition must be formulated.

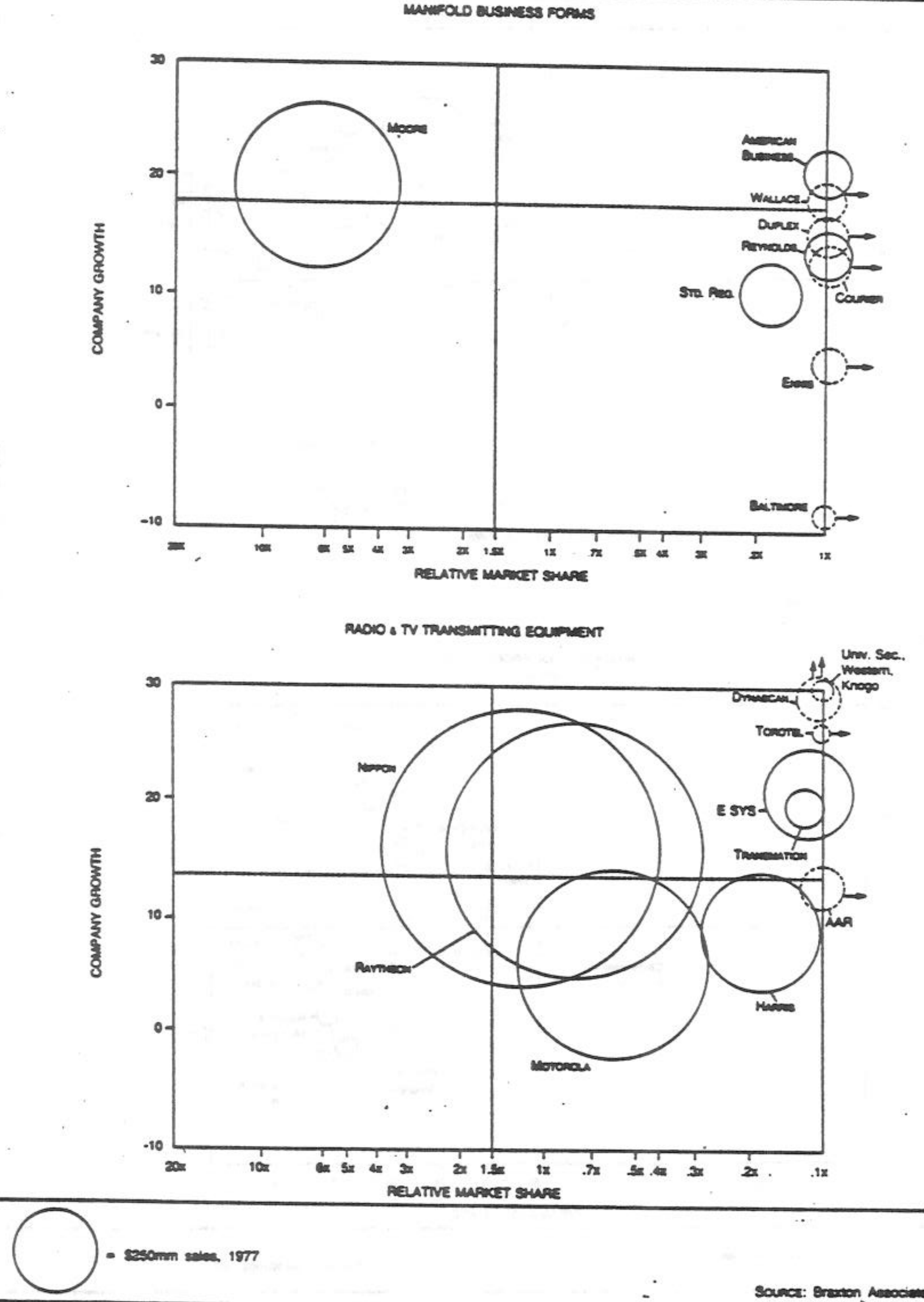
Competitive dynamics in potential sectors of interest is among the best and simplest ways to search for desirable sectors. This is not to say that it is the only factor, or that it might not miss potential opportunities. However, it has the advantage of shifting the focus away from current financial performance and onto competitive position, which is far more likely to signal strong future performance. We see it as a good starting point, if it is coupled with the additional factors we will describe.

Industry Trends

Someone once said, "High winds and strong currents favor the effective navigator." The trick is to get in sync with favorable industry trends. For example, since an increasing percentage of the population will be over 65, for the foreseeable future, demographics and cost-containment efforts favor certain segments of the health care industry. Or, the recent focus on U.S. productivity problems suggests that such sectors as machine tools, CAD/CAM and office automation offer promising futures.

The search does not have to focus solely on finding high-growth sectors, however. Promising candidates may be found in industries that are sound but experiencing low growth. In fact, searching only for high-growth industries can be as fruitless as searching only for profitability. After all, everyone is looking for high

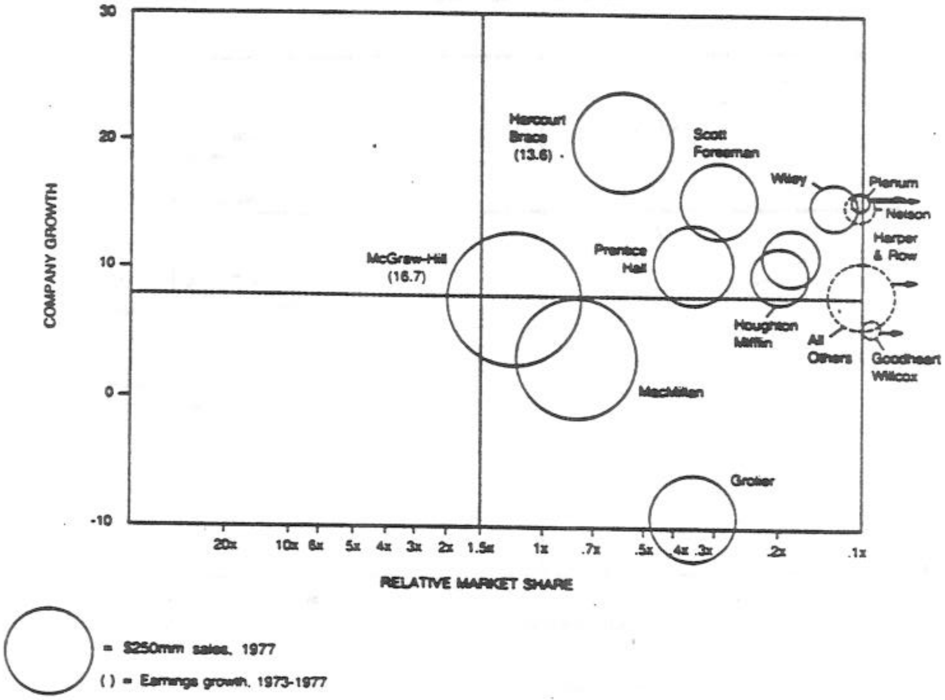
EXHIBIT 2
Sector Graphs
1973-1977



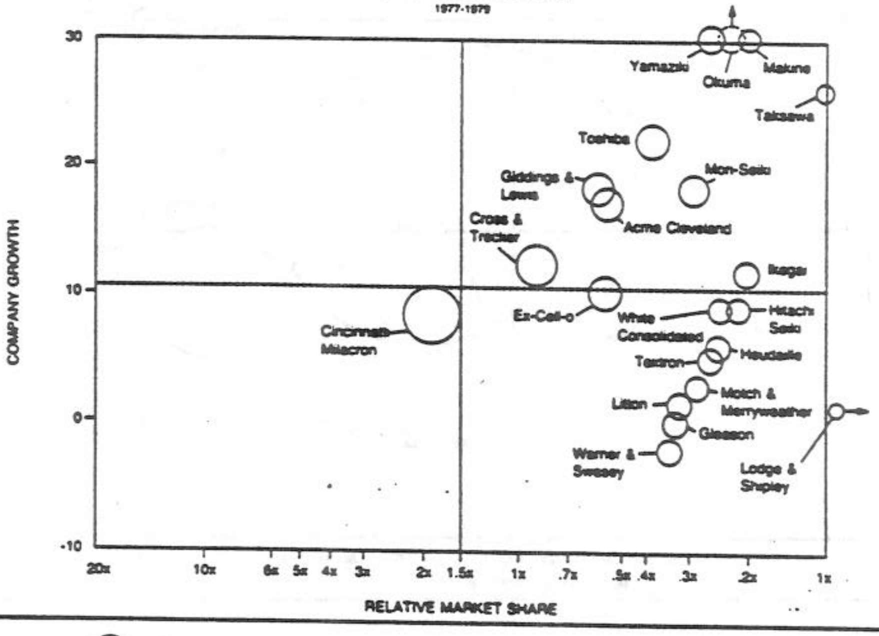
SOURCE: Braxton Associates, Inc.

EXHIBIT 3
Sector Graphs

BOOKS: PUBLISHING & PRINTING
1973-1977



MACHINE TOOL PRODUCTION
1977-1979



= $250mm sales, 1979

SOURCE: Braxton Associates, Inc

growth. In fact, finding an acquisition candidate that could take a different twist to a mature industry or product could be a very smart strategy.

Selecting Promising Candidates

Assume that we have filtered forty or fifty initial sectors of interest down to six or so with favorable competitive dynamics and industry trends. Now, it is time to actually find promising candidates.

The emphasis at this stage turns to determining whether the candidates are configured properly to secure strong competitive positions. Also, their ultimate ability to generate sufficient returns to justify acquisition must be determined. The focus should be on two factors: activity/technology/skill base position and predicted financial performance.

Activity/Technology/Skill Base Position

The candidate's structural position is an important element in predicting success. One way to understand the activity or structural positions of competitors is represented in Exhibit 4. Each block represents an estimate of the overall amount of value-added contributed by each activity in the manufacture and distribution of a hypothetical consumer-electronics product. As can be seen, components, marketing/sales/distribution, and retailing are all significant. Assembly represents very little of the value-added.

The shadings represent the proportion of value-added thought to be done by each competitor. For example, RCA does its own marketing sales and distribution but makes few of its own components, sources the rest and does no retailing. Panasonic (Matsushita) is heavily backward-integrated into components, and Radio Shack is obviously forward-integrated into retailing.

Although these companies may view themselves as direct competitors in consumer electronics, they compete in fundamentally different ways. Predicting which is likely to be successful in a particular product-market segment at a particular point in the product life cycle is not difficult. For products where low-cost manufacturing is key, Panasonic should be well configured to win. When distribution channel clout and brand name are key, RCA should do well. For home computers, which today require significant consumer handholding, Radio Shack should do well.

There is no ideal configuration. Each is different, and the best one depends on the product-market segment being served. When applied to acquisitions, the objectives are: (1) determining which activities, technologies and skills will be key to success, and (2) assessing the combined entity's position in them. Candidates producing the best potential competitive positions for the combined entity should move to the top of the list.

This analysis also leads to consideration of a building block approach to acquisitions. In the machine tool sector, for example, we discover that a significant percent of the current machine tools lack numerical controls. (See Exhibit 5.) Note, however, that a large number of Japanese machine tool exports are equipped with them. This suggests that to be a significant player in machine tools in the future, competitors will have to supply numerical controls. Machines equipped with numerical controls are faster, more efficient, and produce better quality products at lower costs. Perhaps this would call for acquisition of a machine tool company and a strong CAD/CAM systems house. The electronics can probably be more profitably sourced.

Predicted Financial Performance

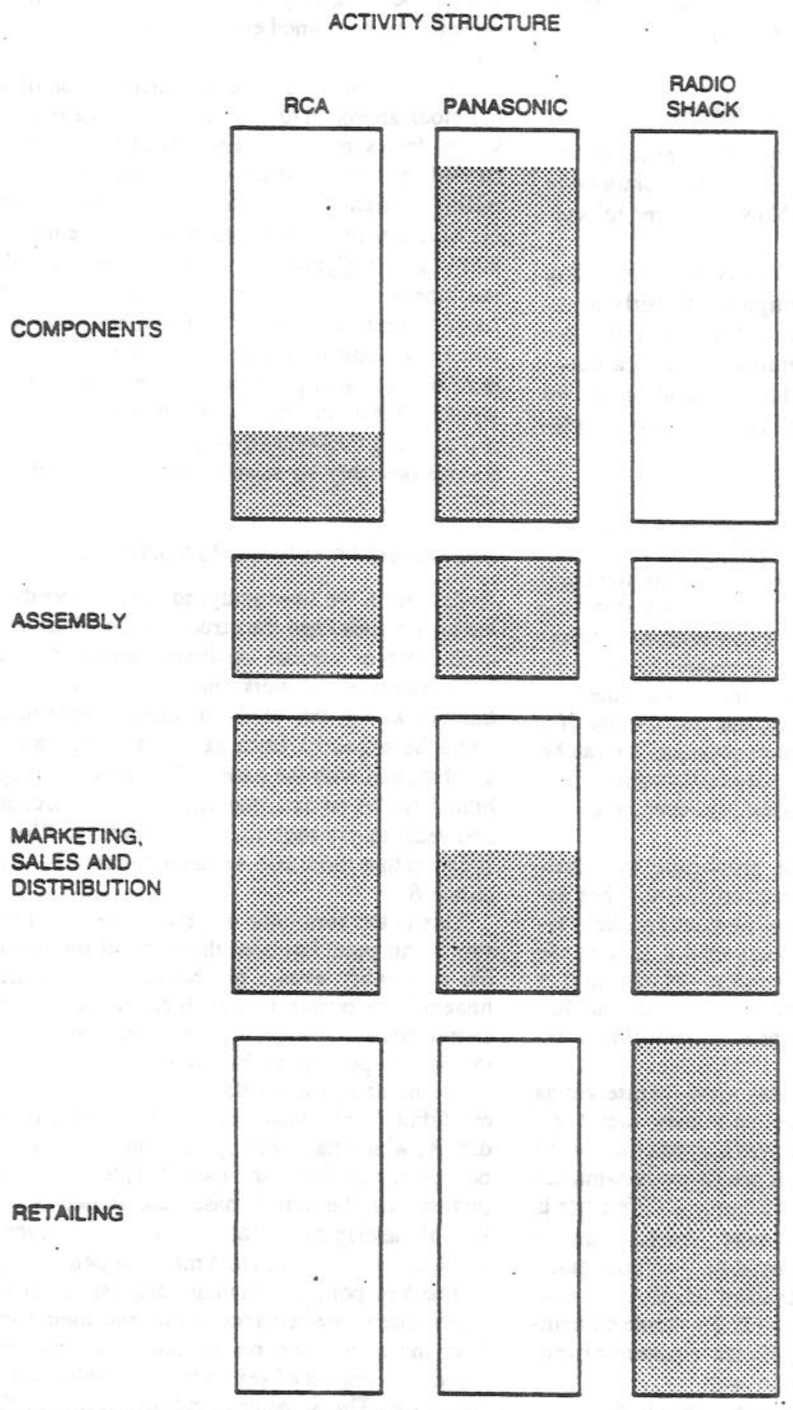
At this point, we have analyzed competitive dynamics, industry trends, and the structural positions of the top candidates in various business sectors. Our list has been narrowed to workable proportions. Now, it is time to assess the likely financial performance that could be expected from each surviving candidate in combination with the parent. The upper display in Exhibit 6 shows an example of returns on purchase price and years to pay back for two candidates. This display suggests that candidate *A* is a far better "buy" than candidate *B*.

This is too simplistic a view, however. If the analysis to this point has been thorough, it should be possible to identify events or shocks likely to affect the financial performance of each candidate. We can then characterize the region of likely outcomes, as shown in the bottom portion of the display.

In this case, the display shows that the returns for candidate *B* are considerably more certain than candidate *A*, which has more upside potential but also more downside risk than candidate *B*. This is a far different picture than the simple base case shown in the upper half of the display. In fact, if you are risk averse, your enthusiasm for candidate *A* may dampen considerably.

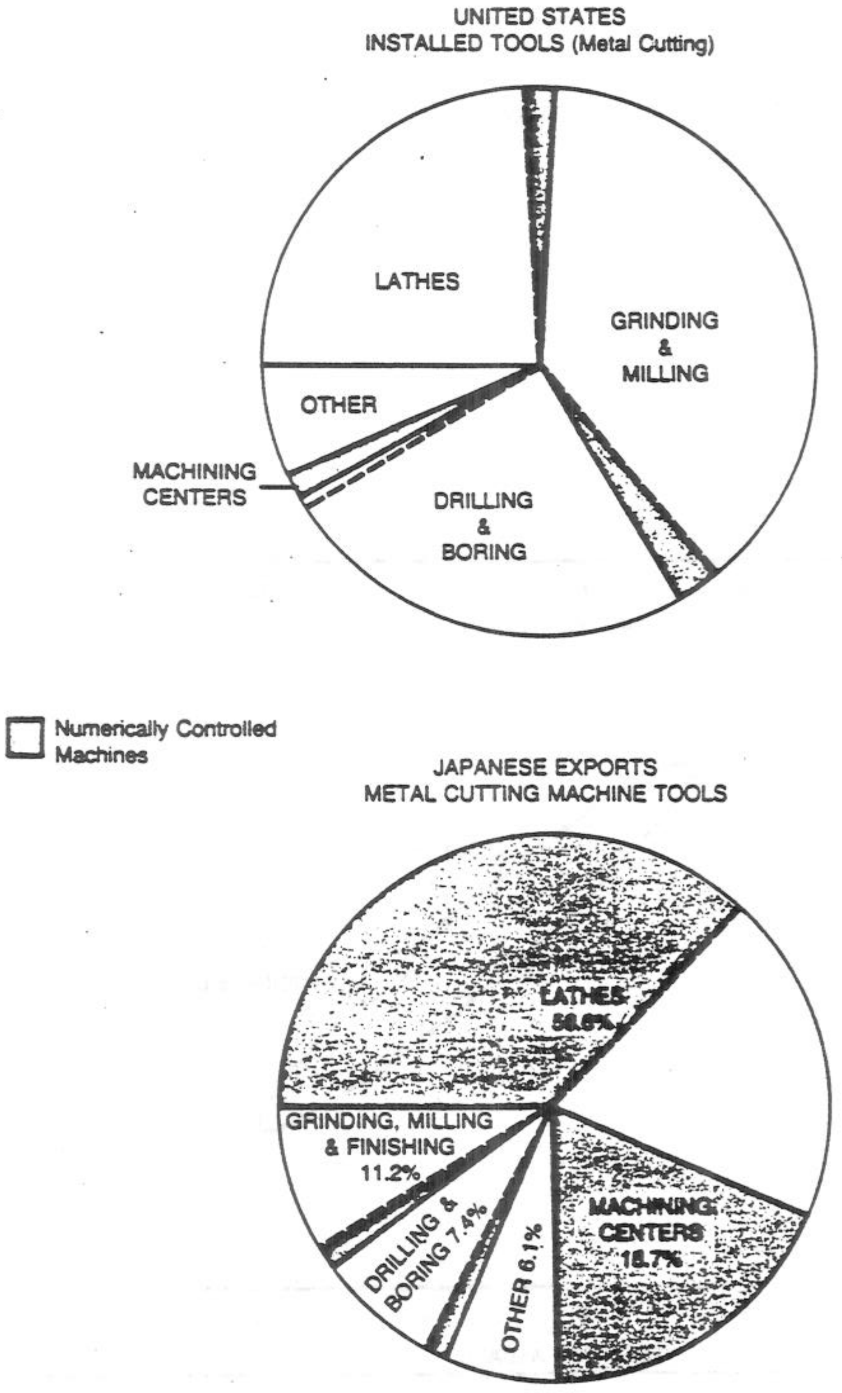
The key point of financial analysis is to focus on likely future performance levels and their variability. Too much reliance on simple base case estimates misses the impact of key events on likely financial performance. The screening and analysis described previously in this article are necessary to develop meaningful financial projections. Given the effort required, this should be done on only those few candidates that survive earlier screens.

EXHIBIT 4
Example Consumer Electronic Product



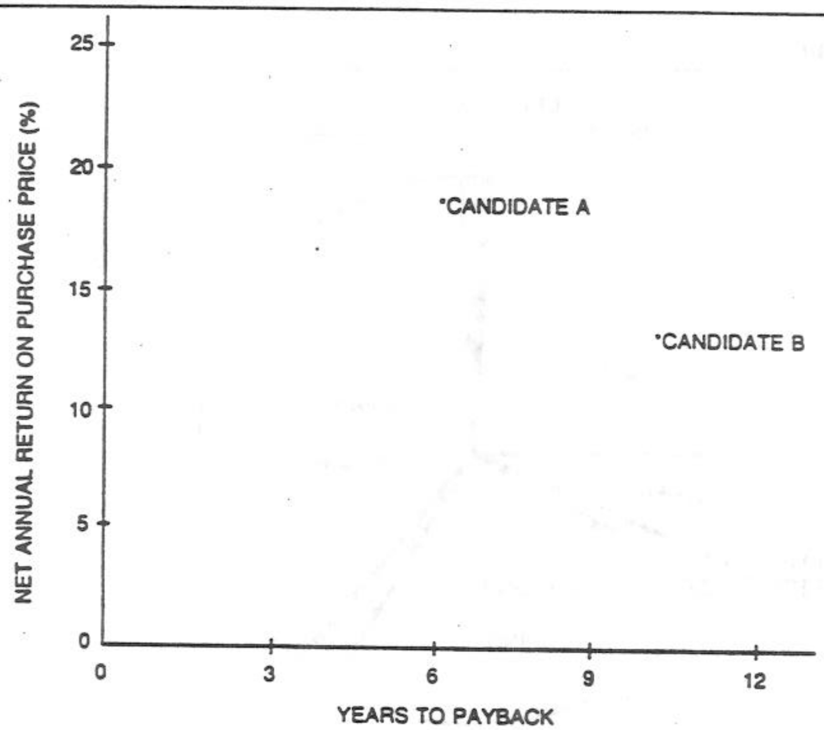
SOURCE: Braxton Associates, Inc.

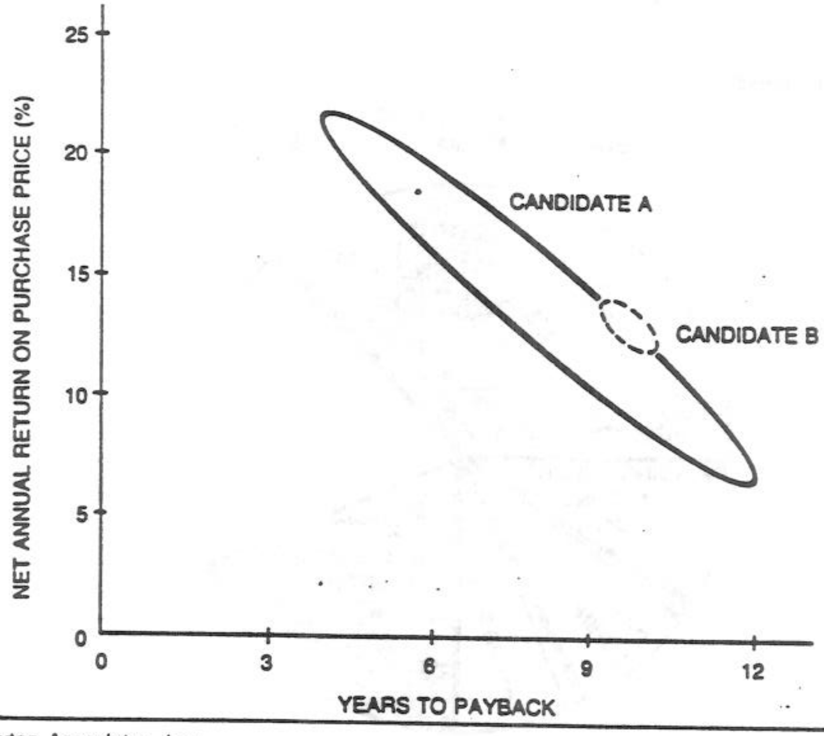
EXHIBIT 5
Comparative Performance



Source: Japan Ministry of Finance
American Machinist

EXHIBIT 6
Example Analysis of Projected Financial Performance





SOURCE: Braxton Associates, Inc.

Recent Examples

In describing examples that fit our strategic approach, we will ignore unrelated acquisitions. These include acquisitions of major scale which take a corporation into a new field (e.g., Mobil's acquisition of Marcor). While rationale might be developed for such moves (e.g., the unavoidable decline of a firm's core businesses), most do not create value. Rather, our examples focus on value-creating acquisitions of related businesses.

Our approach demonstrates that acquisitions make the best strategic sense when they form a natural extension of a company's strategic momentum. Procter & Gamble's acquisitions fit this model well—from its first major move into consumer tissue products (Charmin Paper Mills) to its most recent purchase (the Eaton-Norwich pharmaceutical division of Morton Norwich), last March. Historically, P&G acquisitions have added a missing link to a carefully wrought chain.

In Charmin's case, the product line was a natural extension for P&G. Tissue products control important shelf space in P&G's largest distribution outlet, supermarkets. Even then P&G was the largest individual marketer in the channel. Further, we assume the company had developed knowledge of tissue technology through its Buckeye Cellulose Laboratory. With the product technology knowledge and a strong distribution position, all it needed was manufacturing capability and a ready-made product line. Charmin fit neatly into the existing links and has proven a value-creating acquisition.

Although consumer tissue products are now more mature and are under price pressure, they have been strong cash generators for many years. The immediate products were profitable in their own right. Further, the base and manufacturing technologies led to a line of disposable diaper products which made Pampers perhaps the most successful consumer disposable ever. Charmin plus P&G equalled value.

With the Eaton-Norwich acquisition, P&G may have done it again. In fact, P&G was criticized for paying 24 × earnings ($370 million)—a very high multiple. However, the deal appears to be a classic example of the type that creates value—in major proportions. As with Charmin, P&G is filling in a missing link—access to a distribution channel.

P&G is a world leader in the technology of surfactants (knowledge of calcium behavior in water from their work on soaps and detergents), which has led to its introduction of bone disease drugs. But P&G lacked distribution channels to the pharmaceutical market. By acquiring Eaton-Norwich it accumulated not only a field sales force, but a healthy firm with established products. But these factors are gravy. In this acquisition, broader distribution was the critical source of value.

Will the acquisition work? It has a lot going for it, but effective follow-through is never guaranteed. Company cultures may clash—but don't count on it. Both are staffed by homegrown talent who talk the same language. We place our bet on success.

Another recent example reinforces our point. Those who play video games are aware of the intense competition for the home video cassette market. Warner Communications' Atari unit has a market share about double that of its closest competitor, Mattel's Intellivision. Atari's strengths are image, distribution, and a knack for developing or acquiring the hottest new games: Pac-Man, Asteroids, and Space Invaders. Intellivision's cassette games, by contrast, are considered to be more realistic, as George Plimpton tells us. Mattel seems to have won the technology battle.

However, just prior to the Consumer Electronics Show in Chicago last June, a story broke about a joint venture being formed between Atari and Lucasfilms Ltd., to produce home video cassettes and other products. (Technically, this is not an acquisition, but the principle of how to choose a strategically sound partner is the same.) Lucasfilms created the *Star Wars* movie series and the special effects for *E.T.*, *Star Trek: The Wrath of Kahn*, and *Poltergeist*. Atari possesses the marketing side of the equation; Lucasfilms supplies technology. Technology was the one area in which Atari trailed Intellivision. Now, Atari has captured stronger technology. As with P&G's Charmin and Eaton-Norwich acquisitions, this is brilliant strategy. Intellivision may now lose its one area of competitive advantage.

Summary

As these examples show, acquisitions (or joint ventures) can be an effective way to improve the competitive position of a company and create value for both the stockholder and society at large. To do this, a company's acquisition process must:

- Shift emphasis away from current financial performance and place far more emphasis on competitive dynamics and the structural positions of potential candidates; and
- Be part of an effective overall, ongoing strategic planning process.

We have suggested that companies gaining share on weak competitors are good initial candidates for acquisition. Combined with the parent, these candidates should also be structurally configured to win in the long term versus current or potential competitors. Financial forecasts of candidates' performance can be useful only if the events likely to impact that performance are explicitly taken into account.

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WHARTON REPROGRAPHICS

Scouting the M&A Landscape For Quality Targets

Charles E. Paul Jr.

Modern search-and-screen programs demand strong people applying focused strategies at acquiring companies.

The ideal middle-market acquisition candidate is a business whose entrepreneurial founder has grown the company from start-up to the $40 million to $50 million dollar level. He or she will have been in business 15 to 25 years, may have completed estate planning and merely desires an exit, or may have grown the company to the critical point where more investment is needed to compete with larger companies for additional market share.

The most aggressively courted targets include businesses with dominant positions in niche markets, branded consumer products, or desirable distribution systems. For strategic buyers, they can generate complementary, add-on value to round out product lines, enhance growth, improve economies of scale, or supplement existing strengths and resources. Financial buyers may see them as suitable platforms for leveraged build-ups or as stand-alone investments.

A key problem is that there isn't a large supply of these premium-quality targets, and many search-and-screen programs are not equipped to find the best candidates in the 1990s. We estimate that the currently available pool of privately held manufacturers with revenues in excess of $40 million contains between 2,800 and 2,900 companies. Moreover, in any given year, only 300 to 500 seriously will consider selling.

Typical acquirers develop a strategic plan by using input from fit charts, technicians, consultants, research,

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SEARCHING IN THE INFORMATION AGE

The strategic stakes in 1990s acquisitions have mounted to the point that acquirers themselves should carry the ball in the search-and-screen phase. Good targets are scarce and likely to be stalked by a host of bidders. And both buyers and sellers usually come armed with rafts of computerized information and market intelligence.

To gain an edge, the sagacious buyer should start by defining a clear acquisition strategy and rounding up a team of in-house professionals that can apply it. Job descriptions should include the ability to gather and sift through massive amounts of information and perform sophisticated analyses of targets that meet the company's needs. Identifying good targets in advance, devising fruitful methods of approaching and negotiating with them, and singling out the deals that have the best chances of completion also are key elements of the proactive search program.

and in-house industry analysts. The information garnered from these sources is used as a basis to develop deal flow. No matter how well-organized a firm may be for computing price and value calculations, these abilities are of little use if a prospective acquirer is unable to unearth suitable targets at the right time.

Buyers use a variety of means to attract acquisition opportunities. The most widespread search method — particularly in regard to U.S. deals — is what might be called the "mass market" technique. The buyer ready to make acquisitions circulates a shopping list or criteria statement to a large number of banks and intermediaries and hopes to be courted by all kinds of advisers and consultants.

This method assumes that the best way to attract proposals is to reach the maximum number of eyes and ears. The rationale is hard to refute. The greater the number of sources, the greater the likelihood that sooner or later someone will bring the buyer a candidate that fits its specifications. The problem is that the mass-market method usually seems to bring results "later" rather than "sooner."

Most of the information a company gets is mainly what is already more or less known to the m&a public. Or the candidate in question will be so ripe for acquisition that many other potential acquirers will have identified it also and will be fighting for it.

The company that expresses itself as interested in acquisitions and then sits back and waits for intermediaries to come up with the actual opportunities is by and large going to be sorely disappointed. Therefore, an overwhelming majority of m&a executives assign key staff to orchestrate the search effort from day one and generally structure their searches around a centralized corporate development department that maintains various internal, technical models and external, computerized data bases.

These departments develop regression models and fit charts to sift through scores of possible acquisition candidates in order to isolate the businesses that best fit their criteria. They avoid relying solely on intermediaries to produce suitable targets.

Acquirers committed to the long term use a proactive, relationship approach. They try to spot well in advance the targets that will be the most interesting to them downstream. Knowing that in time these targets will attract the attention of other potential buyers, the farsighted acquirer devotes intense thought and effort to devising ways to facilitate approaches early on. This may involve building relationships with a target or forging commercial links with it, among other actions.

This effort, sometimes developed years before the target is actually ripe for acquisition, provides in some highly competitive industries the best assurance of completing important deals.

Many serious acquirers prefer to take charge of the search effort themselves and rarely wait for bankers or intermediaries to turn up with deal proposals. For the most part, they have departed from actively networking for deal flow because they believe that it seldom produces enough high-quality leads.

However, even the most proactive acquirers should supplement in-house work by communicating their acquisition shopping lists through networks which include investment bankers, business acquaintances, accounting firms, etc. These sources eventually may come up with an opportunity of which the buyer was unaware.

Sourcing of Deals

A key factor that distinguishes the domestic m&a market from that of any other country is information. More information on U.S. companies — listed and unlisted — is publicly available than in virtually any other country. In fact, the ability to find useful information is frequently a competitive advantage for foreign acquirers interested in U.S. m&a situations — much more so than when domestic acquirers look abroad.

Many companies depend almost exclusively on their operating units to source deal flow while others also utilize on-line data bases. Companies and intermediaries sift through the data methodically to identify candidates that fit the buyer's purchase criteria. But a main problem is how to efficiently manipulate the quantities of data these sources produce. In the U.S., about five times more information is available on private and public companies than in Europe. There are more than 25 major on-line systems that are useful for companies actively acquiring in the U.S. and abroad, and they contain at least 2,000 individual data bases. And these sources grow larger every year.

In most European and Asian countries, the lack of data on companies is frustrating and can drive potential acquirers, and costs, up the wall. In the U.S., the opposite is the case. A buyer can drown in data. The challenge is not in gathering data but in categorizing it and knowing how to pinpoint the most critical information.

During a typical search-and-screen process, an m&a team will pull out the names of potential acquisition candidates by scanning data bases according to a number of criteria, including:

- Size of the work force;
- Products and product specifications;
- Geographic penetration;
- Sales turnover and history;
- Earnings history and breakdowns;
- Balance sheet structure;
- Competitive position in main market segments;
- Condition of manufacturing plant;
- Capital requirements; and
- Merger and acquisition history.

Skill Is the Key

With such quantities of data available, a main determinant of success in the acquisition search is the level of data base talent within the buyer's m&a team. If this talent is inadequate, poor search results are likely to follow.

No one can expect good results by putting powerful tools in the hands of people who are not trained business analysts or who lack the intellectual power to match the potential of the tools. The output will be of little value and will create a lot of dissatisfaction among decisionmakers.

Companies that have well-trained, in-house data base staff usually can handle target searches better than their advisers. The major reason is that buyers know their industry, their competitors, their suppliers, and their distributors best, and they usually will have a much better sense of the competitive strengths and weaknesses of individual targets within their markets.

As far as leading U.S. companies are concerned, most of the information is available on-line, but seldom from a single data base. Getting as full a preliminary picture as possible of potential targets usually requires the use of several data bases. This entails a significant amount of on-screen time that can cost many thousands of dollars. A full in-house search-and-screen program for a single acquisition (including computer time, printed literature, searches, and personnel costs) can run from $50,000 to $350,000, depending on the scope of the effort. The costs cannot be recovered if an acquisition search fails to produce a closed transaction.

Committed acquirers try in advance to spot the targets that will be most interesting to them downstream.

The quality of information available for the approximately 12,000 public corporations listed on U.S. stock exchanges obviously is much better than for privately held concerns. Much of the basic information available on-line for private firms is either out-of-date, incomplete, or simply inaccurate.

But in either case, it is fallacious to assume that information appearing on screen must be true. Although many data bases provide reliable data on a regular basis, others only underscore the "garbage in, garbage out" theory. Even the best data bases carry some information that is at best misleading. Therefore, all information coming from any data base should be subject to intense scrutiny before it is used as a basis for actions of consequence.

When the on-line screening process produces data that are insufficient, the only choice open to the prospective acquirer is to use more energetic data-gathering methods.

If a company has defined its selection criteria with care, a broad computer search coupled with information gleaned from operational units and intermediaries may provide from 20 to 100 prospects that might make good candidates.

At this point, most acquirers pick the best targets by using the primary data available. They rank the candidates in order of general attractiveness and by how the targets fit their criteria, which normally encompass such items as the prospect's recent business performance, product lines, strength in distribution, growth rates, etc.

Some buyers develop elaborate fit charts and point systems to help in the ranking process. For example, each prospect will be awarded points for such items as tangible and intangible assets, apparent sales growth (even public companies' published growth rates can be extremely misleading), profitability, product-line fit, manufacturing fit, R&D fit, and market position versus the competition.

With fit charts and point systems, prospects that are generally weak or deficient in too many criteria automatically are discarded. Typically, the first screening eliminates 75% to 85% of the original "long list" of prospects.

Although most firms perform their analyses reasonably well up to this point, the crucial but frequently overlooked factor in acquisition strategy is simply what means a prospective acquirer uses to contact management of the candidates.

Why Most Searches Fail

In an auspicious environment where acquirers are few and targets are plentiful, virtually any technique for sourcing deals and contacting the candidates will work. However, the 1990s offer no such environment.

Acquisition plans based on the "typical" search-and-screen process falter for a number of reasons. One is that with the standard program, companies often fail to dig deeper — beyond the obvious targets — to find less sought-after, non-auction candidates that still are desirable. In addition, industry buyers may be experienced and qualified in running their own operations but lack the dealmaking skills required to entice a reluctant owner to the bargaining table. Moreover, the constraints on a buyer's time cause many would-be acquirers to take ill-advised short-cuts.

A main determinant of success in the acquisition search is the level of data base talent in the m&a team.

From initiation to completion, it can take up to a year to complete a deal. Performing all acquisition-related functions in-house can deplete a firm's resources and diminish its overall effectiveness. But turning outside for help can create problems if the intermediary lacks the resources and capabilities needed to add value to a search and to approach sellers the right way. Poorly written correspondence or undiplomatic contacts can tarnish the buyer's name and hamper the acquisition efforts.

Designing a Search Program That Works

The first step to devising a search program for the 1990s that overcomes these problems is to carefully select a pool of professionals who understand the marketplace and the temperament of sellers. The talents required of dealmakers include the practical skills derived from completing multiple transactions, thorough research capabilities, an intuitive feel for numbers, ingenuity and creativity, and consultative selling powers.

There are advantages to engaging an adviser to assist in the search. The cost becomes a variable expense item associated with the assignment over a fixed overhead expense. Professional m&a advisers already own many of the research sources for market data and have the requisite business skills to assess the players and conduct interviews. However, the intermediary should be carefully screened by the acquirer to determine the experience level of its deal team and its approach to transactions.

Whether a search is conducted strictly in-house or combined with outside assistance, the team assembled to handle the project must be directed to dig deep. It must develop a complementary research effort that focuses not only on the obvious targets but every remaining potential target. That involves gathering additional information, much of which may not be available on standard data bases, such as:

- Pricing policies;
- Opinions on the quality and stability of management;
- Overall business strategies and objectives;
- Perception of the target company by competitors and customers;
- Ownership and control; and
- Technology, R&D, new product development, etc.

Gathering such data requires considerable ingenuity. Professional periodicals, product literature, and publicly available price lists are key sources of information for starters. But the most valuable information often comes from the target's competitors, customers, and suppliers.

A suitable method for collecting this qualitative information involves conducting informal surveys, usually by phone and occasionally in person. There is no substitute for talking to people who know about the candidate and have done business with it. The information in standard sources is at best sketchy. Public companies seldom break out results of their smallest business units, and private companies divulge little.

Consequently, the ultimate data base for prime-source information is in the minds of the people who

own or work in companies similar to those being targeted. These "person-to-person" inputs are especially vital when researching "hidden sector" companies — firms with particularly low profiles.

When confidentiality is an important factor, professional advisers, unlike intermediaries who act primarily as finders, can wring out every possible bit of information about a potential target while maintaining the buyer's anonymity.

Some of the methods for gathering competitive intelligence include conducting field interviews and surveys among writers, executives, and publishers of trade journals and researching trade guilds, associations, and participants in trade shows, and perhaps visiting retail stores to conduct surveys of products and categories. Without revealing the names of their clients, the researchers can gather and analyze information rapidly on virtually any industry and its field of acquisition candidates.

When companies do their own person-to-person intelligence-gathering, frankness and honesty are important. One of the secrets to being successful in this kind of research is to be above-board with the people being interviewed. It is not necessary to identify the buyer or the target. Usually all that is required is telling the interviewees that the company is thinking about an investment in the area and wants to gain an understanding of the industry's players and dynamics. If approached properly, people like to talk about their expertise, their company, and their competitors.

Table 1: Contact Points at Target Companies

Type of Target	*Person to Contact*
Small, privately held owner-managed company	Owner-manager
Small, independent, non-owner-managed company	Key shareholder
Division of a large company	Senior manager at corporate headquarters, i.e., chief executive or chief operating officer, or influential board member, banker, or financial adviser
Small unit of a large company	Senior manager at corporate headquarters, i.e., head of corporate planning or chief operating officer
Private mid-sized to large company	Key shareholder, influential board member, banker, or financial adviser
Public mid-sized to large company	Chief executive, main banker, main legal counsel, board member close to chief executive

Once the fact-gathering process has been completed, the buyer will be ready to make a weighted assessment of each candidate remaining on its short list and to rank the survivors in order of overall attractiveness. During this process it is important that the buyer revisit its original strategy statement to ensure that the match is correct.

An acquisition search stretches over a considerable period of time, and while an m&a team has been searching it is very possible that the competitive environment in an industry has changed. Top competitors may have announced new initiatives or merged or new players may have entered the field. So, the original strategy may have to be fine-tuned to account for these changes. It is imperative to make sure that the criteria selected six months earlier are still valid.

The next step is to properly rank the candidates. Ranking obviously embraces such items as strategic compatibility, financial compatibility, cultural similarities, competitive strengths and weaknesses, and how these elements are complementary to the buyer's own strengths and weaknesses. But apart from the obvious, heavy weighting in any final ranking of candidates must be given to the feasibility of the transaction itself.

In the words of Jean Gandois, chairman of Pechiney SA of France, "Acquisitions are like apartments. Some apartments are very attractive, but to get them depends on two conditions. First, the apartment has to be for sale, and second, you have to be able to afford it."

It is not a worthwhile allocation of m&a resources to pursue deals that are difficult to complete.

Thus, even if a target seems especially attractive in terms of the buyer's acquisition criteria, it may have to be dropped from the final list simply because the owners won't sell and getting them to change their minds would be nearly impossible. Or the prospect can be dropped when it can be reliably predicted that the owners would hold an auction and drive up the price.

Making Contact

The final part of the search-and-screen process is establishing contact with the owners or managers of the target company to get acquainted with them and to verify whether there is any potential for a deal. Once

Table 2: An Acquisition Search Model

Senior Management
Sets acquisition criteria

↓

Search Team
Internal staff, brokers, external consultants, or combination of all

↙ ↘

Publicly Held Firms

Data Bases: Bloomberg, Securities Data, Predicasts, Dialog, Lexis/Nexis, Disclosure, Dun & Bradstreet, etc.
Literature: Annual Reports, SEC filings, prospectuses, industry reports, Industrial Outlook, press releases, other media reports, etc.
Expert Inputs: Consultants, securities analysts, industry observers, etc.

Privately Held Firms

Data Bases: NewsEdge, Infotrak, Thomas Register, Ward's Directory, OneSource, Dialog, Lexis/Nexis, D&B, etc.
Literature: State filings, trade directories, industry reports, press clippings, etc.
Network: Suppliers, customers, your own sales force, intermediaries, trade shows, industry observers

↓

Long List of Prospects
Ranking of prospects according to fit chart, points system, etc.

↓

Short List of Candidates

↓

Fact Books on Each Candidate
Management profile, shareholder profile, production configuration, customer loyalty, suppliers, technological strengths, distribution channels, product literature, price lists, inputs from surveys, competitive intelligence, etc.

↓

Preliminary Analysis
Competitive strengths and weaknesses, financial compatibility, strategic compatibility, cultural similarities, overall feasibility of an eventual transaction

↓ ↘

Go-Ahead Decision **Rejects**
Formulation of a contact strategy for remaining candidates

↓

Contact

the buyer's senior management has given the go-ahead for contact to be made with a target, the question of who to contact in the firm depends on the size and ownership of the target. Table 1 lists likely first contacts in a variety of situations.

On the buyer's side, first contact is usually made by either a senior officer of the buyer or by an intermediary acting for the buyer. In most cases, the first contact should be done by an intermediary. The reason is that the intermediary is not the buyer and will not be held accountable by the seller or by regulatory agencies for disclosure.

The first contact should be through a letter that clearly articulates the buyer's strengths and vision and includes research on the target that will invariably catch a seller's interest. Sellers are skeptical of unsolicited calls and may prefer time to consider a sale in private. Experience has shown that sellers respond to timely

and intelligent letters, especially when they show signs that a true strategic investigation is being made and that the buyer is not just on "a fishing expedition."

But when the buyer itself is initiating contact, it will almost always be by telephone, since letters from principals can have extremely far-reaching legal ramifications. When the target is a public company, any written hint of an offer for the company almost certainly alarms directors and managers and is likely to set off a chain reaction of defensive measures, board meetings, and other steps that are hard to keep secret. Even in the friendliest of offers, most deals require stringent scrutiny by corporate executives and board approval before they can proceed.

The goal of a first telephone call is simply to arrange a meeting. It is not designed to explain that the buyer is on the m&a trail or to get the target to reveal whether it might be for sale. If the first conversation is a follow-up to a letter that asks whether the target would consider a sale, the goal should be to explain the inquiry and confirm some of the nonconfidential information already in the buyer's possession. Depending on the temperament of the seller, the next step, if possible, is to arrange a meeting to explore the relevant issues important to both sides.

Almost every good private company in America has been approached at some time by a prospective buyer. This is, after all, a deal-oriented country. So, unless the company is known to be on the block, the buyer's first approach has to be very subtle. Nine times out of 10, the target's owners will know what the buyer is up to, but there still has to be an effort to rouse their interest.

The main rules of thumb are to be informal, friendly, and have something interesting to discuss. In most cases, the prospective buyer will avoid talk of acquisitions and instead will focus on possible business cooperation with the target.

Starting the Courtship

To distract the target's attention, the buyer might have a legitimate, non-acquisition business proposal to offer — in the licensing or distribution area, for example. This first contact may be but the first step in a relationship that may take months, or even years, to nurture. The object should be to get together, to perhaps do some business, to establish a relationship, and to explore the possibility of a transaction.

In first-contact situations, foreign buyers have a tactical advantage over U.S. companies because it is relatively common for overseas businesses to get in touch with American firms for global networking purposes.

If it seems appropriate, the first face-to-face meeting might take place on the target's premises. Or the two sides might prefer a neutral location such as a hotel or conference center. It's useful to schedule meetings with target companies while industry trade shows or fairs are taking place, but probably unwise to meet at trade show sites, where it is hard to keep meetings secret. If too visible, the meetings are likely to set rumors in motion and attract the attention of competing bidders.

Checking Out the Results

The evidence is clear and unequivocal that the marketplace for successful acquisitions is more competitive than ever and selling shareholders are more informed than in the past. Deal autopsies reveal the costs of failed acquisitions and the depletion of resources such as time and human capital, and the bad impression that poorly orchestrated searches leave in the minds of sellers can't be erased. The failure of important deals also can have a negative impact on shareholder value when these deals are not done and growth initiatives are not accomplished.

As a result, companies should draft and execute a careful and analytical approach to acquisition search starting with the selection of the right personnel, whether in-house or third-party advisers.

To monitor the effectiveness of a search program and whether it is producing value in the form of viable acquisitions, management must consider these questions:

How well is the current system working? Measure the proportion of good targets being identified against the number of closings taking place. A system consistently yielding a high proportion of "doable" transactions is probably working well.

Are sufficient time and professionally trained business analysts being devoted to the rigors of data searches, personal interviews, travel, and categorization of information? Most companies have adequate staff for valuing deals and integrating acquisitions. But they lack the human capital and the time required to promptly pursue leads originating from operational staff and intermediaries and to stay abreast of companies that might be considering a sale.

How much better is the current methodology than the least-cost alternative? Determining a return on investment requires baseline data for comparison. Such data provide the basis for making informed decisions and proper allocation of resources. ■

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WHARTON REPROGRAPHICS

Corporate Growth by Strategic Planning Part II:

Developing a Plan

Stanley Foster Reed

This is the second of a three-part article describing a highly refined technique developed by Stanley Reed for analyzing and rating opportunities for corporate growth—be it via internal expansion or external acquisition. His unique approach to corporate diversification has been described at earlier stages in its development in two previous articles: "Corporate Diversification: A Logical Approach" (Vol. 5. No. 4. pp. 4-16) and "The Fit-Chart Approach to Corporate Diversification" (Vol. 7. No. 2. pp. 17-32). The present article builds on these earlier discussions, revising and extending them on the basis of actual consulting situations in which he has tested out his theory and on the basis of his experience in teaching "fit-charting" in hundreds of seminars around the country.

Part I emphasized the importance of developing a logical corporate strategy. Part II describes a Wheel of Opportunity and tells how to "do" a corporate Fit Chart session. Reed enumerates many Supplements and Complements. the Fit-Chart variables that are generated to point up a company's strengths and weaknesses. These variables will be used in Part III to actually rank industries (first) and individual companies (second) for their potential to shore up a company's weaknesses and utilize its strengths to fullest advantage.

This is an eminently reasonable and creative approach to corporate diversification that brings much-needed objectivity to the acquisition search process. yet recognizes (and takes advantage of) the intense subjectivity of the endeavor.

Part I of this article ended with the words "A proper strategy will identify an opportunity first and will then evaluate resources (or the lack of them) in terms of that strategy." That, in a nutshell, is what the Wheel of Opportunity and Fit Chart are all about.

THE WHEEL OF OPPORTUNITY CONSTRUCT

A Wheel of Opportunity is a step-by-step method of depicting the interface between a company's present operations and the rest of the world. It isn't a *plan*. It's a picture that you create. But it can be the basis for a plan when each of the opportunities defined around the Wheel is analyzed for "fit" via a Fit Chart. (See Table 1, page 9 for example.)

Industrial Organization

The approach begins with the discipline of Industrial Organization, a course taught on most of the major campuses in the U.S. and abroad. "IO" teaches the economics of the relationships of a company's operations to those of its suppliers, customers, competitors, and potential competitors. All antimerger antitrust law is built on the economics of these relationships which are shown on Figure 1.

A meaningful Wheel can be made for any operation, anywhere in the world. For illustrative purposes, the writer has chosen to make a very simple Opportunity Wheel for XYZ Consultants, a mechanical engineering company with four offices—Detroit, Chicago, New Orleans, and Houston. (See Figure 1.)

XYZ is concerned with its future. It wants to grow, but needs to know the best direction to head. The owners ask: How should we proceed from here? What will make us a better, more profitable company? *What* opportunities exist, and *where* are they? Of all possible directions we can expand, which are likely to prove most advantageous? Let's discover what the interface between our operations and the universe really looks like!

The process

Having decided to construct a Wheel of Opportunity, XYZ Consultants assembles its top people. This group may include Board members, consultants—in fact, anyone who knows a good deal about XYZ's business and is a person of good will.

As a Wheel of Opportunity depicts (see Figure 1), the operating interface for any company has six facets: horizontal or market integration—direct competitors; market extension—new markets or territories for existing product and service lines; backward vertical integration—suppliers; forward vertical integration—customers; product or service extension—new products or services in territories presently being served; and free-form entry—new products in new territories. Each and every possible move can be erected on one or the other of these interfaces.

It will be immediately apparent that by requiring planners to proceed step-by-step in a logical way, that random processes of looking for opportunity in unfamiliar high-risk fields and territories take place only after the more familiar, low-risk entries have been considered. Furthermore, step-by-step planning of the type and kind described here insures that market information about present lines is actually in hand.

The step-by-step process also offers another *large* dividend. It will tell the planners what *mode* seems to be the most efficient. For when the Fit Chart is complete, the scores of the candidate entries in each of the three modes will be summed. This figure will be divided by the number of candidate entries, providing an average efficiency for each entry in that mode. It is then that a strategy of, say, Vertical Integration, developed "heuristically" out of the real data of the real world in which the operation under study finds itself, will be logically adopted because the average entry is higher in that mode than in the other modes of Market Intensification or Diversification. (See Table 1.)

And there are other reasons for proceeding step-by-step. In the past, the Business Judgment Rule protected the director and executive of public companies from liability for losses from ill-conceived "whyncha" entries (e.g. "Whyncha go into the bowling alley business? Bowling is hot stuff!"). But that day is long gone. There must be *reasons* for a merger or acquisition. The purpose of this careful, step-by-step process is to develop the reasons *for* entry *before* entry!

The Horizontal or Market Integration

The first interface that should be considered is the Horizontal. That's the interface with present competitors. For any principal line of endeavor, it is essential that growth in the marketplace and market penetration be known in order to apply the strategy developed in Part I as shown on Exhibit 1 (see *M&A*, Summer, 1977, Vol. 12, #2, page 13). In the instant case, XYZ has offices in four cities, each of which has a different market/growth, market/share relationship. They conform to the four conditions shown on Exhibit 1. Each calls for a different strategy. Logic might tell you what to do in each case, but run them through the Fit Chart anyway and see.

Step One

Enter on the Opportunity Wheel the principal market (geographic) areas served by present product lines or services noting growth in the market and the market share currently attained as "High" or "Low."

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The Market Extension

The second interface that should be considered is Market Extension. It asks, what other geographic areas not now significantly served are there? What is the growth rate of demand for our present products or services in those territories? The market areas are entered in whatever breakdowns make sense and the growth rates are entered. (Where there are partially developed markets all over the world, it is probably best to enter the U.S. markets on the Horizontal Integration interface and the foreign markets on the Market Extension interface.) For XYZ, this yields potential domestic entries:. Baltimore, Las Vegas, San Diego, and Birmingham; and foreign entries: the Mideast, West Africa, Indonesia, and Brazil.

Step Two

Enter all future potential markets for the present principal line or lines by logical geographic breakdowns. Enter growth rates for sales in the market.

The Horizontal or Market Integration plus the Market Extension make up the Market Intensification Mode. In general, it is probably good strategy to explore these two interfaces thoroughly for these are the low-risk interfaces.

The Backward Vertical Integration

Next look at what you buy. At this stage, rather than particular suppliers, you want to list the items or services you buy in significant quantities. These then are listed in natural groupings and *the percent of purchases in that industry is related to the company's sales dollar.*

The significance of making an entry into a supplier industry is primarily to reap the benefits that will be obtained from increased sales of the supplier when expansion takes place in the Market Intensification Mode. A company whose sales dollar is composed of 20 percent costs of one commodity, and who is contemplating doubling sales in the industry by the Market Intensification Mode, should look first to the profit potential that might be realized from the resulting doubling of the sales of any acquired supplier. There is often more profit to be realized from this move than can be realized from elimination of overheads in horizontal or market extension moves. This is truly "synergy." The percent is entered so that sectors with insignificant percentages of purchases can be dropped.

In the XYZ case, Environmental Planning is at 13%, Urban Planning at 9%, Geophysical Consulting at 6%, Surveying at 5%, and Community Planning and Architectural Design at 4%.

Step Three

Lump all suppliers of each kind together and enter the percentage of your annual purchases from each. Relate to sales dollar.

The Forward Vertical Integration

The next most logical move, it would seem, is to take a look at those to whom your products or your services are sold. Again you are interested in the percentage of your total sales to each *kind* of industry. In the case of XYZ, they sell most of their services to architects—70 percent, with lower percentages sold to turnkey contractors and to developers of shopping centers and industrial parks.

Step Four

Lump all customers of each kind *together and enter the percentage of annual sales to each.*

The Backward Vertical Integration and the Forward Vertical Integration make up the Vertical Integration Mode.

Where there is a high level of technology, vertical integration can pay off in a consistently better product produced at lower and lower cost because parts and materials can be produced to exact tolerances—neither over-engineered, which cuts into profit margins, nor under-engineered, which creates assembly and service problems. Product planning, research and development, product engineering, and in some cases, distribution and service functions, are all aided by vertical integration. Inventory control in times of tight money, and reduction in sales costs are other factors that work in favor of vertical integration. And in times of shortages, owning its own supplier has saved many a company from failure.

The Product or Service Extension

For most company executives contemplating "growth," the potential for doing new things is the big attraction. This desire to "do something new" is nearly universal and, if properly controlled, can lead on to impressive victories in the marketplace. But if improperly controlled, if composed of "whynchas" and other random activities, it can bring a company down.

In the XYZ case, the group simply outlines potential areas for entry. There are no rules for generating entries except that to go diamond mining in Africa probably will not get through the Fit Chart and so it may as well be left out. However, the drama of the Fit Chart can only be demonstrated when a few such "whyncha's" are injected.

In a case in Japan that the writer consulted on, a company hugely profitable in automobile accessories decided to develop a strategy and a plan since their "diversification" program wasn't working out. In all, fifteen entries were developed around the Wheel, including five entries already made. A Fit Chart was developed and the ten potential and five actual entries were rated. With rank-order 1 being the most desirable, the five entries already made ranked 11, 12, 13, 14, and 15! The company decided to get out of the worst four immediately, using the cash to effect the 1, 2 and 3 rank-ordered entries.

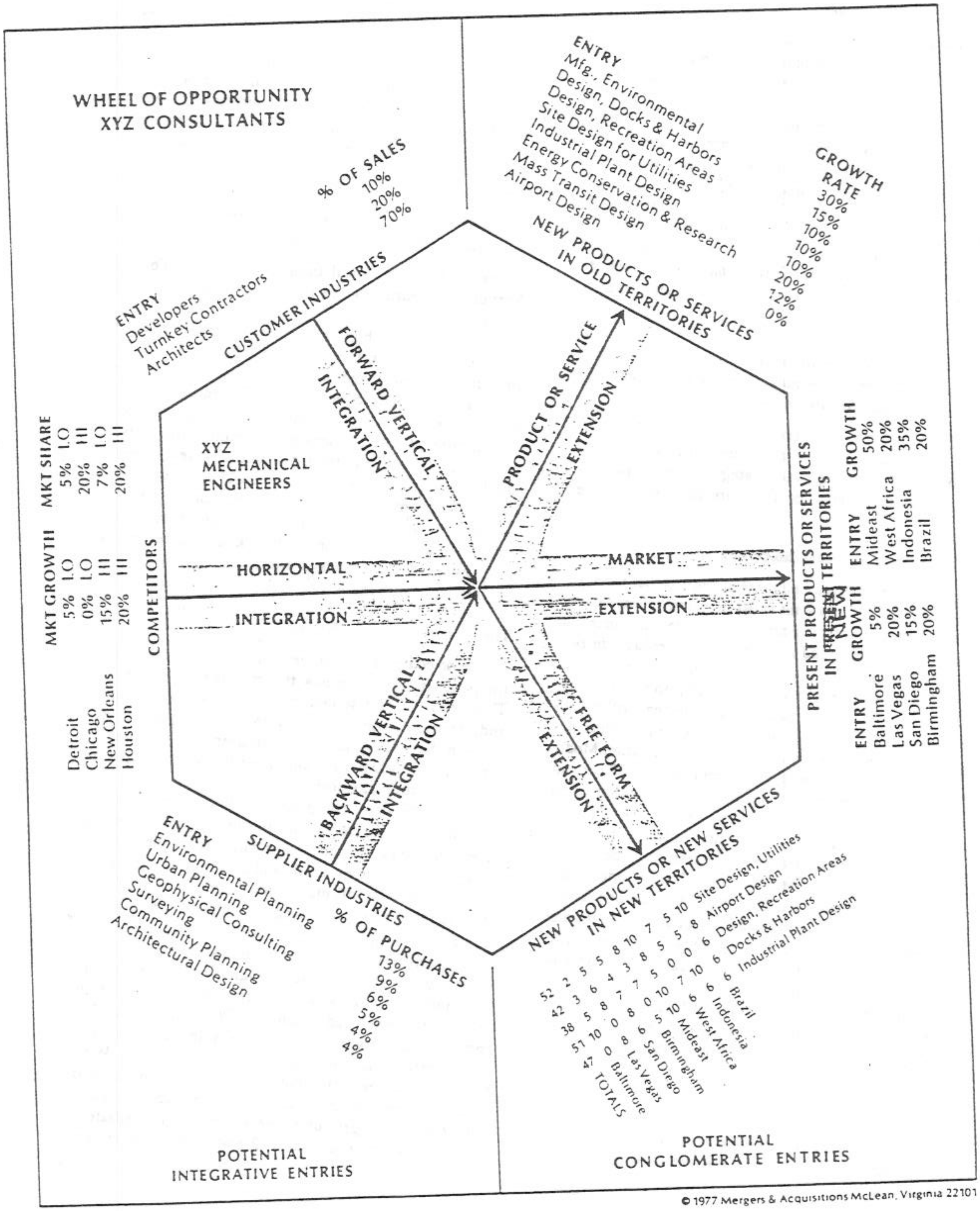
WHEEL OF OPPORTUNITY
XYZ CONSULTANTS
% OF SALES
10%
20%
70%
ENTRY
Developers
Turnkey Contractors
Architects
CUSTOMER INDUSTRIES
ENTRY
Mfg., Environmental
Design, Docks & Harbors
Design, Recreation Areas
Site Design for Utilities
Industrial Plant Design
Energy Conservation & Research
Mass Transit Design
Airport Design
GROWTH RATE
30%
15%
10%
10%
10%
20%
12%
0%
NEW PRODUCTS OR SERVICES IN OLD TERRITORIES
FORWARD VERTICAL INTEGRATION
PRODUCT OR SERVICE EXTENSION
XYZ MECHANICAL ENGINEERS
MKT GROWTH
5% LO
0% LO
15% HI
20% HI
MKT SHARE
5% LO
20% HI
7% LO
20% HI
Detroit
Chicago
New Orleans
Houston
COMPETITORS
HORIZONTAL
INTEGRATION
MARKET
EXTENSION
PRESENT PRODUCTS OR SERVICES IN NEW TERRITORIES
ENTRY GROWTH
Baltimore 5%
Las Vegas 20%
San Diego 15%
Birmingham 20%
ENTRY GROWTH
Mideast 50%
West Africa 20%
Indonesia 35%
Brazil 20%
BACKWARD VERTICAL INTEGRATION
FREE FORM EXTENSION
ENTRY
Environmental Planning
Urban Planning
Geophysical Consulting
Surveying
Community Planning
Architectural Design
SUPPLIER INDUSTRIES
% OF PURCHASES
13%
9%
6%
5%
4%
4%
NEW PRODUCTS OR NEW SERVICES IN NEW TERRITORIES
52 2 5 5 8 10 7 5 10 Site Design, Utilities
42 3 6 4 3 8 5 5 8 Airport Design
38 5 8 7 7 5 0 0 6 Design, Recreation Areas
51 10 0 8 0 10 7 10 6 Docks & Harbors
47 0 8 6 5 10 6 6 6 Industrial Plant Design
TOTALS Baltimore Las Vegas San Diego Birmingham Mideast West Africa Indonesia Brazil
POTENTIAL INTEGRATIVE ENTRIES
POTENTIAL CONGLOMERATE ENTRIES
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FIGURE 1

From this you can see that the sell-off decision can be made using the Opportunity Wheel and Fit Chart. All actual or potential product (or service) lines are put in their proper sector and, in effect, rated against each other. Candidates for sell-off are generated as it becomes obvious that a company is engaged in activities that do not "fit" with the rest of the company's present operations nor with its future, higher-ranked opportunities.

With the aid of an outside consultant generally familiar with all phases of the consulting industry, XYZ racks up several entries. In this case, the estimated growth rates are for XYZ's present geographic market sectors. XYZ's possible Product or Service Extension entries follow: Airport Design, 0%; Mass Transit Design, 12%; Energy Conservation & Research, 20%; Industrial Plant Design, 10%; Site Design for Utilities, 10%; Design of Recreation Areas, 10%; Design of Docks and Harbors, 15%; and Manufacturing of Environmentally-related Items, 30%.

Where there are very small present sales to (or purchases from) an industry group, and there is interest in taking a look at that industry for possible entry, it is probably best that such entries be entered in the Product or Service Extension sector rather than in the Vertical Integration sector.

Step Five

Enter all possible new product or services extensions that might reasonably be considered to be logically related to present activity. And, if you have the time, throw in a few "whyncha's" as a final check on the Fit Chart numbers!

The Free-Form Entry

The final sector of the Opportunity Wheel is the sector posing the highest risk. It is the sector where one enters new industries in new geographic territories.

In the case of XYZ, it would mean taking a look at the eight potential service extensions and looking at each of them in the eight new territories under consideration. That means 64 combinations to be judged and to be run through the Fit Chart—too much work. To be practical, you construct a matrix, take a look at the growth rates in each industry and area, and score the entries on a 1-10 basis. For XYZ, the winners are the top six which rated 10: Docks and Harbors Design in the Baltimore area; Industrial Plant Design, Docks and Harbors Design, and Site Design for Utilities in the Mid-East; Docks and Harbors Design in Indonesia; and Site Design for Utilities in Brazil.

Step Six

Enter what appears to be the best of the Product or Service Extension candidates combined with the best Market Extension candidate areas for present lines.

The Product or Service Extension and the Free-Form Entry make up the Diversification Mode.

There you have a typical Wheel of Opportunity—done, to be sure, for a little mechanical engineering firm in the Midwest. But that doesn't matter. An Opportunity Wheel can be constructed in this manner for *any* company or operation. Next comes the Fit Chart, which will show how efficient these potential entries might be.

THE FIT CHART CONSTRUCT

Begin with the notion that there are two things to be gained from any look at a universe of opportunities. First, what is it that you lack? What is it that will benefit you by *complementing your weaknesses?* And, second, what is it that will benefit you by reinforcing, exploiting, or *supplementing your strengths?* Decisionmaking in this area is difficult for, in general, leaders of business enterprises are of two types: those who are concerned with *complements* (we should get into something new) and those who are concerned with *supplements* (but what will it *do* for us?).

Most programs of diversification take one approach or the other. They either concentrate on exploitation of new and different opportunities *or* they concentrate on exploitation of known strengths. The basic concept of the Fit Chart is to break down the psyche of the company forming up a strategy into both types: What do we lack that can be filled by a new entry? And what strengths or assets, human and physical, do we have that are underutilized?

Thus, the Fit Chart (Table 1) has two sections, COMPLEMENTS and SUPPLEMENTS—Complements for those who are concerned with lacks and differences, and Supplements for those concerned with strengths and resources. Anyone can find industry entries heavily weighted on one side or the other. But the trick is to find entries with high values on *both* sides—*and they can always be found!*

- *Why are Complements first?*

The answer is simple. The writer is Complement-minded—he has a tendency to think in terms of differences, of disparities rather than of similarities. However, he is enough of an executive to know that he must have around him the kinds of people who will also ask the $64 million question, "Yeah, but what will it do for us?" But to answer the question, either Complements or Supplements may come first.

- *How does a Fit Chart session begin?*

First, how many people should attend? That has been a difficult question to answer for a number of years. However, experience has shown that, in general, below

FIT CHART for XYZ CONSULTANTS

	COMPLEMENTS																					SUPPLEMENTS																						
	Seasonal Swings	Long-Term Cycle	Random Effects	Entry Resistance	Growth in Billings	Profit Improvement	Effect Min. Mkt. Penet.	Effect Max. Mkt. Penet.	Price Independence	Better Customer Mix	Add Marketing Method	Increase Total Customers	Full-Lining	Image Improvement	Tax Shelter Generation	Proprietary Process	Purchase Clout	Customer Clout	Reduce Overhead	Reduce Unalloc. Time	TOTAL COMPLEMENTS	Board Fit	Top Mgt. Fit	Middle Mgt. Fit	Staff (Skills) Fit	Quality Control	Est'g. Bidding, Pricing	Supplier Fit	Gen'l Marketing Fit	Salesmen Fit	Customer Fit	Finance Fit	Offices Fit	Scale Fit	Ind'l Relations Fit	Regulation Fit	Acct'g & Cost Control	Budgets P. S & F	EDP Fit	Prof'l Org'n Fit	Synergy	TOTAL SUPPLEMENTS	TOTAL EFFICIENCY	RANK ORDER
Column Number	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20			
1st Approximation	0	30	10	0	50	30	30	10	10	10	10	10	100	30	30	30	30	10	40	50	520	0	100	50	70	0	10	10	10	10	70	10	0	0	0	30	20	20	10	10	50	480	1000	
2nd Approximation	X	50	0	X	70	0	30	0	0	0	0	0	150	10	30	30	10	40	50	50	520	X	100	50	100	0	0	0	0	0	100	0	X	X	X	20	20	0	0	0	90	480	1000	
3rd Approximation	X	60	X	X	70	X	30	X	X	X	X	X	150	0	0	0	0	40	90	70	510	X	120	40	120	X	X	X	X	X	100	X	X	X	X	0	30	X	X	X	80	490	1000	
"Normalized" Value	X	50	X	X	60	X	40	X	X	X	X	X	150	X	X	X	X	30	90	90	510	X	150	20	150	X	X	X	X	X	100	X	X	X	X	X	0	X	X	X	70	490	1000	
Horizontal Integration																																												
Detroit		0			0		40						150					30	90	40	350		150	20	150						100										20	440	790	3
Chicago		20			10		0						150					10	90	40	320		150	20	150						100										20	440	760	4
N. Orleans		20			30		40						150					30	90	40	400		150	20	150						100										20	440	840	1
Houston		20			40		0						150					10	90	40	350		150	20	150						100										20	440	790	2
Market Extension																																												
Baltimore		20			20		0						0					0	0	60	100		100		150						50										70	370	470	
Las Vegas		30			20		0						0					0	0	60	110		100		150						50										60	360	470	
San Diego		30			30		0						0					0	0	60	120		100		150						50										60	360	480	
Birmingham		30			20		0						0					0	0	60	110		100		150						50										60	360	470	
Mid-East		20			60		0						0					0	0	60	140		50		150						30										60	290	430	
W. Africa		20			40		0						0					0	0	60	120		50		150						30										60	290	410	
Indonesia		20			50		0						0					0	0	60	130		50		150						30										60	290	420	
Brazil		20			30		0						0					0	0	60	110		50		150						30										60	290	400	
																																										Average	560	
Mkt Intensification Mode																																												
Vertical Backward Integration																																												
Environmental Planning		50			50		0						0					30	70	30	230		100		30						40										60	230	460	
Urban Planning		50			20		0						0					10	30	30	140		100		30						30										60	220	360	
Geophysical Consulting		30			20		0						0					10	30	0	90		70		0						20										60	150	240	
Surveying		10			0		0						0					0	0	0	10		70		10						20										60	150	160	
Community Planning		20			20		0						0					10	90	70	210		70		50						20										60	200	410	
Architectural Design		10			10		0						0					10	90	90	210		70		150						20										60	300	510	10
Vertical Forward Integration																																												
Architectural Designers		10			10		0						0					0	90	90	200		150		150						100										0	400	600	6
Turnkey Contractors		0			20		0						0					0	10	90	120		150		150						100										0	400	520	9
Developers		20			10		0						0					0	0	90	120		150		150						100										0	400	520	8
																																										Average	420	
Vertical Integration Mode																																												
Product or Service Extension																																												
Airport Design		20			0		0						0					0	60	20	100		50		50						100										60	260	360	
Mass Transit Design		20			30		0						0					20	50	50	170		50		50						100										60	260	430	
Energy Conservation & Res		30			40		0						50					20	50	60	250		60		20						50										60	190	440	
Industrial Plant Design		0			10		0						150					10	90	60	320		150		150						50										60	410	730	5
Site Design for Utilities		10			10		0						100					10	80	20	230		70		90						50										60	270	500	
Design of Recreation Areas		30			20		0						100					10	40	30	230		70		50						20										60	300	430	
Design of Docks & Harbors		30			40		0						0					20	30	30	150		100		70						0										60	230	380	
Mfg. Environmental Items		20			50		0						0					30	0	50	150		50		100						0										60	210	360	
Free-form Extension																																												
Site-Des. Util.-Brazil		20			30		0						100					10	0	20	180		70		70						20										60	220	400	
Site-Des. Util.-Mideast		20			30		0						100					10	0	20	180		70		90						20										60	240	420	
Des Docks & Harbors-Indonesia		20			40		0						0					20	0	30	110		100		70						0										60	230	340	
Des Docks & Harbors-Mideast		30			60		0						0					30	0	30	150		100		70						0										60	230	380	
Des Docks & Harbors-Baltimore		30			50		0						0					30	0	30	140		100		70						0										60	230	370	
Industrial Plant Des. MidEast		20			30		0						150					10	0	60	270		50		100						50										60	260	510	7
																																										Average	410	
Diversification Mode																																												

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TABLE 1

seven makes the results too sensitive to one person's vote. At the other extreme too many participants make the analysis drag on too long—to the point where the cost/benefit ratio exceeds 1.0. The writer suggests that 10 is a good round number, and between eight and 12 is fine. (Part III of this series will tell about a new electronic voting device designed by the writer so that as many as 25 can take part in a Fit Chart session.)

• *Should participants be line or staff or both?*

The writer's personal proclivities lie in the direction of restricting the voting input to line, with the informational inputs generally coming from staff. But this observation applies only to development of a Fit Chart, not a Wheel of Opportunity.

• *Should Chief Executives and Chairmen vote?*

Absolutely. Contrary to popular belief, the average C.E.O. wants to stay out of the process of developing a strategy for fear that he will powerhouse his people into accepting *his* program. He's attended enough management development seminars to know that the only way that he will ever develop a strong executive group is by moving them into the decisionmaking line. He can certainly do that in the tenuous business of strategy and planning. But he may not abdicate his role as the C.E.O. He must vote. (Part III will explain the voting procedure which utilizes a special form of the Delphi Process developed by the author for strategic decisionmaking in which C.E.O. sandbagging or bandwagoning is eliminated.)

• *Do you have to split Complements from Supplements? Or can you mix them?*

They can be mixed, but the totals of the weights for Complements and Supplements for any one entry are interesting to contemplate and much can be learned from their study; so it's probably best to separate them.

• *Where should a Fit Chart session be held?*

A Fit Chart session should be held off-site since interruptions will destroy the continuity that is so necessary to the development of a solid plan. But off-site sessions create problems too. Many questions are posed during the development of a Fit Chart that can only be answered by reference to company and industry records. The planning group must either be quite efficient and gifted factwise or they will skimp the answers.

All in all, then, on-site sessions are best, but forbid participants to accept telephone calls. (One solution to the telephone problem is to meet from 9:30 A.M. to 11:30 A.M., then adjourn for a half-hour of office work. Lunch is from 12:00 P.M. to 1:00 P.M., office work again from 1:00 P.M. to 2:00 p.m., and then an uninterrupted session from 2:00 P.M. to 5:00 P.M. This yields five solid hours of work, allows the office fires to be either built or put out, and with the emotional levels that can be raised in a good, hot Fit Chart session, is probably all that the average executive can stand.

• *What about evening sessions?*

No wisdom for you here. They have been productive and also non-productive. It depends on the group, really. On balance, no. People need the time to think through the events of the day—to second-guess on Tuesday rather than six months later when an acquisition comes up for a vote!

• *The process. How does it start?*

It starts with an explanation of the difference between a Complement and a Supplement. It is not an easy concept to grasp and many do not understand it right-off. Heavily Complementary-minded people have trouble with Supplements, and vice versa. But such people are in the minority in the upper ranks in most major corporations.

• *What comes first?*

Everyone present must be convinced that anything that they can say about a company can be converted to a ratable variable. For instance: "We should get away from the union." That's a Complement. It can be entered as a Fit Chart variable in various ways such as "Non-Union Industry."

The next item might be, "We've got to find something else we can sell to our 28,000 present customers." That's a Supplement. It is called "Customer Fit."

✓ • *Should "operating" variables be separate from "financial" variables?*

Yes. While it *is* possible to include *financial* variables in the evaluation, it is probably best to develop a strategy from an operating standpoint first—to look for opportunity first. These opportunities will be rated through the medium of the Fit Chart, after which the Financial Strategy can be derived from the universe of opportunities that rate well on the Fit Chart. For one thing, each potential entry around the Wheel will have not only a rank-order or priority for entry, but will also have an "efficiency." This efficiency rating is then used to compute a proper discount rate for projected earnings streams of specific acquisition candidates in order to determine price.

To summarize, financial strategy derives from predictions of future happenings. Once the Wheel and Fit Chart are done, you can begin developing a financial strategy intimately tied to your Wheel and Fit Chart.

• *What does one do with all the Complements and Supplements that are generated?*

First, through a series of successive approximations, they are weighted and ranked according to their importance in your situation. The goal is to reduce the list to 10-20 prime variables, which can then be used to rate each potential entry. One ends up with every industry under consideration ranked in order from best to worst. Only then does the search for actual companies begin. The Fit Chart comes in handy again in the consideration of candidate companies for acquisition: a quick run through the Fit Chart will show whether or not the company being considered actually fits or not. And the efficiency—the final score—can be used to price the entry.

COMPLEMENTS

A complement is something that completes or makes perfect. Thus, in generating Complements in a Fit Chart session, the idea is to pinpoint characteristics of businesses or industries that will compensate for your company's present weaknesses. The identified weak areas may be inherent in your industry or may be unique to your company. Either way, if you're going to expand by means of merger or acquisition, it makes sense to shore up any existing problem areas.

CYCLICAL COMPLEMENTS

1. Seasonal or Annual Complements

The search for a seasonal complement is known as the "coal and ice" problem: if you sell coal in the winter, you should sell ice in the summer. Otherwise your capital is unemployed in the summer. (On the Supplement side would be sales to your ice customers, using the same trucks, the same workers.) If you're in the coal or ice business, a Fit Chart variable for this item is a cinch. But for most companies with seasonal problems (or perceived seasonal problems), the solution may not be so easy. What about manufacturers of Christmas tree ornaments? Are beach balls a seasonal complement? Perhaps, but don't forget that beach balls can't be manufactured using the ornament equipment. And that beach balls are bought by buyers who don't buy Christmas tree ornaments. That they insure differently, etc. But rather than reject it out of hand, always write it down and run it through the Fit Chart. Perhaps it *might* get through!

2. Long-term Cyclical Effects

Depending on whether you believe (or actually follow) the automobile cycle, the sun-spot cycle, or the women's skirt-length cycle, you should find a complementary entry.

And one can always be found! When the economy turns down, something always goes up! In stock market parlance, these are known as "defensive" entries (and not because the Department of Defense or the old War Department always managed to dream up a war to pull the economy back up, as some people firmly believe). For a firm making OEM automobile parts, the perfect complementary entry during bad times when people don't buy new but keep the old car, is replacement parts. Replacement carburetors, water pumps, radiators, clutches, and transmissions fail more frequently, and parts rebuilders' sales go up 300 percent!

In bad times, sales increase for hundreds of items—home repair books, some kinds of educational activity, recreation, (and it used to be that even junk food sales went up when the economy went down). Seek and ye shall find, because defensive entries are always there. The problem is to search long enough to find entries that will generate values on the Supplement side as well as complementing your unfortunate cyclicality.

Many believe that Keynesian economics still governs national political economy theory—that when times get bad the government starts spending. For those who believe this, or know this, an entry in a government-dependent industry is a good Complement.

3. Product Life Cycles

All products and services seem to have a life cycle and the management literature is loaded with articles on the subject. Figure 2 depicts a typical product life cycle curve. It is obvious that, apart from financial strategy, a front-end growth industry in the "cash hog" stage is a complementary entry to one that is in the "cash cow" stage.

On the front end, high growth usually eats up all the cash produced from the profit stream, and a lot more too because support of the growth requires more and more cash for capital investment until the growth curve levels off. For a nylon, the base may be 30 years long, which means that nylon could have produced a deficit cash flow for duPont of many millions of dollars for many years. But duPont had a lot of cash cows that were throwing off cash to support it. Now nylon is a cash cow and is supporting a host of new cash hog ventures by duPont.

The problem with most companies in the cash hog stage is that they tend to make entries into other front-slope industries. They are also usually undermanaged—because of their growth they simply do not have the skilled manpower to solve all of their day-to-day problems. And yet somebody on the board says: "Our stock is up. Now is the time to buy another company." So they sell some more stock, buy another growth company, spread themselves a little too thin, and they're in trouble.

What they should do is buy a cash cow company that they can milk! Why? First of all, cash cows are cheap—cheaper than borrowing money. They sometimes

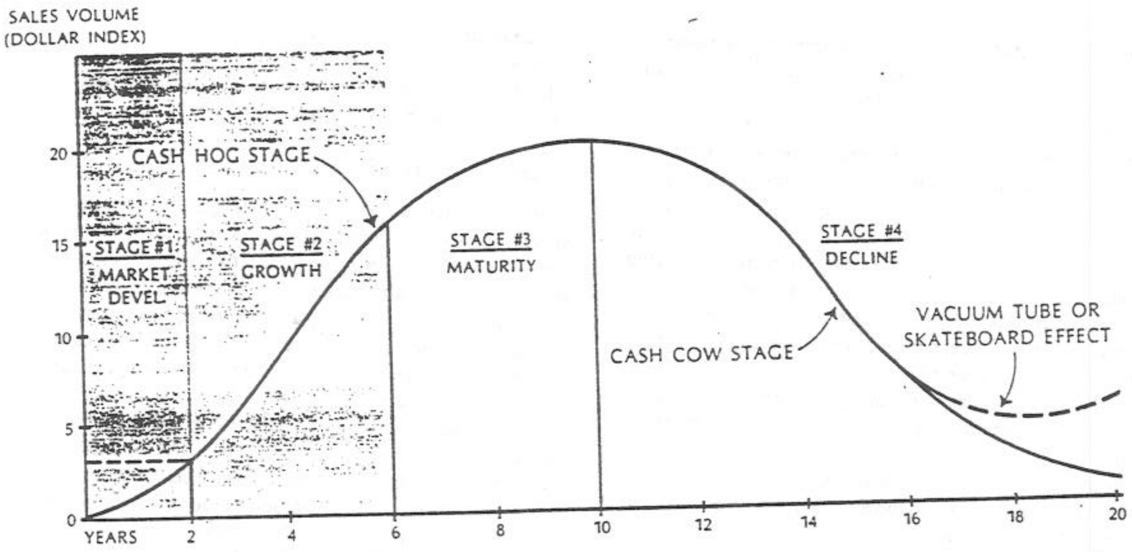

FIGURE 2
Typical Product Life Cycle Curve

throw off excellent middle management and even good top management.

And then there is always the chance that you will get another renascent phenomenon like skateboards. Or take the case of vacuum tubes, a real winner that TV brought back when there were only five competitors left rather than the ninety-five of radio's peak.

It might be possible to generate a Supplement out of this variable too. You could say, "We know how to operate on the front slope. We know how to manage a growth company, how to control it, how to finance it. This can be a powerful argument, and it could get entered as a Supplement such as "Ability to Manage Growth" or "Ability to Slop the Hogs!" If you believe it's sound, enter it—it's your Fit Chart! But you better be sure!

The complementary entry for a front slope company will be "Acquire low-growth lines." And for a back slope company, "Acquire high-growth lines."

4. Random Factors

The final entrant under Cyclical Effects has been invented for those companies whose fortunes are consistently affected by random factors such as weather, fads, modes, fashions, and political happenings—anything completely random and unpredictable.

The complementary entry is, of course, *more of the same*. For only by expanding your base can you eliminate the peaks and valleys. When there is drought in California, there is rain in Iowa. When you hit twelve dry holes in a row in Montana, you bring in two gushers in Texas. If, on Seventh Avenue, you guess wrong and cut velvet one year, linen the next, seersucker the next, and you're wrong every time, you're out of business. But if you expand your base, merge with others, cut three or four different materials each year, your mistakes will disappear into your successes. Survival is assured. This is the reason that only very large construction companies survive. They spread their base around the world so that the *average* of losses due to weather conditions or bad geology or strikes, all of which have a dramatic effect on the bottom line, is reduced to a simple cost of doing business—just like insurance, it *is* insurance!

So the proper solution for an operation plagued by random effects is simply more of the same—which might be translated into the heading "Expand Random Base."

ENTRY AND EXIT THREATS

1. Entry Resistance

Most managers believe that their operations are quite open to entry either from within or without. In one case, a Chairman thought that his company was completely vulnerable to entry from within because 15 years ago, one of his vice presidents had resigned, bought some second-hand machinery, cut prices, and had taken some ten percent of his customers. But the former VP couldn't hack it and he was broke in one year. No one ever tried it again. The business was highly resistant to entry, but the Chairman couldn't stop worrying about it. This is not to say

that possible entry from Japanese imports, competition from suppliers and customers, etc. can be ignored. But these threats must be analyzed realistically.

For instance, who believes that there is protection in high technology against competitive entry by split-off? Many do. But it's a myth. Let an industry grow from nothing to significant sales in a highly technological industry and there will be new competitors by the score—most of them by split-off from the founding group who created the technology in the first place. There are certainly lawsuits, but it takes years for the patent office to issue patents, and then it takes many more years to resolve them in court. In the meantime, there is always a proliferation of competition by split-off—and, in general, eventually all the survivors make money.

In the context that we are concerned with here, what are the threats that involve the merger/acquisition equation? Here they are:

1. Threat of competitive entry by split-off.
2. Threat of increased competition by the merging of competitors.
3. Threat of increased competition by the merging of competitors with suppliers and/or customers.
4. Threat of entry from potential market extension entrants.
5. Threat of entry from potential product extension entrants.
6. Threat of entry from free-form entrants.

Threat No. 1 has already been discussed.

Threat No. 2 can be a real threat if, by merging, competitors can effect economies, such as the economies of scale, or can add the number of accumulated units produced and move on down the cost line and cut prices in order to gain greater market share (see Exhibit 1, Part I).

Threat No. 3 is usually more real in highly technological industries. But given the problem of shortages, one must weigh what *might* happen if a supplier bought a major competitor or a major competitor bought a major customer.

Certainly *Threat No. 4* is very real for anyone. It is the super-successful operator in New England who moves his men, methods, and merchandise into the Middle Atlantic region and wipes out the competition. Better buy him before he buys one of your competitors and wipes *you* out of the market!

Threat No. 5 is hard to estimate, but have any of your competitors been bought up by a go-go company moving into your field? Many a company has awakened one day to find their markets preempted by a go-go entrant inaugurating new merchandising programs and his markets dry up like tears after a wedding! Does it make sense to buy him first?

Threat No. 6, the final threat in this series (note that we are simply going around the Wheel of Opportunity in our analysis), is that it looks good to someone from the outside looking in. In that case, the only defense you have is to grab off a large share of the market any way that you can get it, in order to scare him off.

2. Exit Resistance

Exit Resistance is a hard-to-classify factor. Diversifiers should stay out of businesses that they cannot get back out of. Surely, any business that is a regulated public utility cannot be abandoned. But there are more subtle problems involved. Buy a gray iron foundry (or start one up de novo), then try to close it down when it becomes uneconomic to operate. The whole town turns out! Nursing mothers scream at you while suckling their young. The local padre crosses himself in your presence as though *you* have sold out to the devil! And there are parades and pickets and the mayor himself comes to call with the whole city council to boot to beg you not to close down the foundry! A moral: If you are already in a business that is hard to get out of, make sure that you don't enter another with the same characteristics.

GROWTH

1. Growth in Sales

This is one of the more difficult entries to analyze because there is always a tendency to combine growth with other variables such as investor appeal. But to make the system work, variables must never be combined. In this case there are two growth variables: the first and more important one for our purposes of judging entry is the absolute rate of growth in the industry. This means *Growth in Sales*. And it is quite important that this figure be accurately established since, by experience, growth in sales in an industry often has the highest number of points assigned to it by the group doing the Fit Chart.

2. Growth in Profits

The second growth factor is *Growth in profits in the industry*. Is it a front-slope industry with only modest profits due to the draining away of profits by R&D expense which, upon maturity, will return many times the earlier rates? Or is it an industry that is so cutthroat pricewise that a decent profit rate will be impossible to obtain over any reasonable period?

INVESTOR APPEAL

There are many reasons why investor appeal is important. As previously explained, this variable is entered to fix a number on the importance of making an acquisition purely for the purpose of increasing the price/earnings multiple that is accorded to a stock, *in-*

dependent of its earnings history. It is the multiple accorded to the stock by the investment or the investing community independent of growth in either earnings or sales. We are trying to assess the importance of making an acquisition that will raise the base multiple. Because this usually involves the stockholders taking some temporary dilution, it is of immense importance that it be carefully considered. There are eight things to consider!

1. Raising the P/E (Price/Earnings Ratio)

The absolute differential. Earnings for earnings, growth for growth, does the candidate industry enjoy a multiple higher than yours? We might call this one Plus P/E Differential.

2. Image Intensification

One of the crosses that the conglomerates have had to bear since the days when they pumped their earnings per-share growth by accounting legerdemain, is that they have had much lower price-earnings multiples than they deserve from their long-term financial record. Some of this might be ascribed to the bad taste left in the mouth of the investing public by the precipitate drop in their prices when the accounting trickery became common knowledge. But it is too serious a deficiency to be cast off that lightly—something more is involved.

It is this writer's opinion that the investing public likes to know what a company *does*. Ford makes automobiles, GE makes electrical equipment, Gulf is in the oil business. But if you are a housing company with interests in beef-packing and insurance, the investing public will stay away from your stock simply because they don't know where you come from. If you believe this to be true, and you want to create investor appeal, you'd better take steps to intensify your image to the investing public. You can do this through the acquisition process. If you're in oil, chewing gum and amusement parks, and "energy" is where the action is, make a series of energy acquisitions, let the public know about it, and watch your multiple go up. If you are already in anti-pollution and theatres, buy more anti-pollution companies and your stock will reflect the easing of the confusion in the minds of the investing public as to "who you are." We call this Complement "Image Intensification."

A case in point is the recent sale of the Dutch Boy name and operations by NL Industries to E.L.T., Inc. NL's strategy dictated that it move backward, away from consumer items such as Dutch Boy house paint, toward the basic extractive processes. They had found they had more success there than at the consumer level. So they sold off Dutch Boy to E.L.T., Inc., a mini-conglomerate. They changed their name from E.L.T., Inc. to Dutch Boy, Inc., hoping that some of the very solid image that Dutch Boy had built up over the past half-century would rub off on all of its operations. It was a smart move. With the Dutch Boy name, they not only may be able to attain some kind of pricing independence, but their P/E went from 6 to 12!

3. Smoothing Out Yo-Yo Earnings

If your industry and your company has a yo-yo earnings history, enter an industry that has a complementary history. When you enter and pool, it will smooth out, and your multiple will respond accordingly.

4. Leverage Response

If your company cannot borrow long-term on an equitable basis simply because lenders are unfamiliar with your industry, you need to enter an industry where lending practices are well-established, then leverage the new *combined* companies at the rate given to the new entry alone.

For example, you have a chain of 50 retail stores specializing in sports clothes in the medium price range. It is very difficult to get money to finance current operations, and long-term financing for expansion is impossible. *But*, buy two or three profitable dress manufacturers and a large long-term loan at a reasonable rate may be much easier to obtain simply because there are many more lenders that understand manufacturing than retailing. This ability to leverage, to borrow money, will, up to a point, have a beneficial effect on the Price Earnings Ratio.

5. Going Public by the Back Door

If you are a private company and want to grow by acquisition, unless your cash flow is very substantial, you'll need to be public so that you can use your stock to make acquisitions. You can "go public" by acquiring a public company which, theoretically, will raise the multiple of your stock. So enter an industry where there are *many publicly-owned* companies.

6. Getting Listed

Though the statistics are not as supportive of the theory as most believe, getting listed on a stock exchange will raise your stock's multiple. Get listed by entering an industry where there are many listed companies and then take one over.

7. Listing Improvement

How important is it to improve your investor appeal by effecting a listing improvement? Certainly, if your long-term plan is to make a series of acquisitions using your stock, listing it is a near-necessity. But there are many companies that you simply cannot buy unless you are

listed on the NYSE. So, if you want those benefits, take over a NYSE company before you begin your plan.

8. Listing Insurance

Finally, there is the problem of *maintaining* a listing. Currently, some 25 companies listed on the NYSE are in danger of losing their listing either because they do not have enough net worth, enough stockholders, or enough action in their stock. An acquisition can cure the default.

MARKETING

By far the most important effect to be considered in any merger/acquisition or de novo entry is marketing. "If *you* don't sell it, the sheriff will" should be borne constantly in mind. For no matter how good a product is, no matter how filled it is with quality, beauty, and utility: if you can't sell it, it isn't worth two cents! The marketing-related Complements and Supplements are many and varied. Here are the Complements, beginning with the most important of all marketing variables, "Market Penetration."

1. Effect Minimum Market Penetration

Much has been written about market penetration and its importance to survival and growth. One rule of thumb says that if you don't have ten percent, you have nothing. Another says that you can't make it unless you are a market leader—that is, you must have at least 1.5 times the sales of your nearest competitor. This article is not a dissertation on marketing but is simply generating a rubric into which those marketing variables that do apply to the new entry can be entered. To answer this question, you must ask "How important is it that we effect greater market penetration?" "Can we buy up a competitor and increase our share—at least to the survival point?" "Can we extend our market geographically, buy a major competitor in that market, one in which we do not now compete, and thus effect greater market penetration as a whole?"

2. Effect Maximum Market Penetration

Next is the question of effecting *maximum* market penetration. Can you get up to the magic 35 percent where survival is assured and where Return on Sales is at a maximum?

3. Attain Pricing Independence

This is a textbook item. Ask an Allis-Chalmers bulldozer salesman and he'll tell you that a Caterpillar bulldozer of the same size and power will command a substantially higher price. No one really knows why. But it is true of thousands of items in the United States. If you do not have such an item in your product mix, perhaps you'd better try to acquire one. It may pull your whole line along.

4. Attain Better Customer Mix

Another textbook variable. Say that you're strictly in OEM. Apart from the effects of business cycles, you are completely dependent on a few *kinds* of customers and, as a group, they usually have power and they use it. But if your standard lines can be lengthened and you can add consumer goods, or even pick up sales to government, you can shed some of this dependency. (This item applies to defense contractors especially. They try to complement defense work with at least 50 percent non-defense work.)

5. Increase Absolute Market Size

If you have 70 percent of a $10 million national market, where are you going? Nowhere. If you have run out of market, get into something bigger.

6. Add Marketing Method

The graduate schools of business always have a ready supply of case histories showing the tragedies that befall those companies that are super-skilled in the use of only one merchandising method. The classical case was that of Lestoil that used saturation television to *pull* the product out of the warehouse and into the stores—the housewives simply demanded it! But they had no *push:* no standing displays, no print, no salesmen, etc. Procter & Gamble, drooling at the huge market opened up by Lestoil, brought out Mr. Clean and by using *every* kind of marketing method, knocked Lestoil out of the box in short order. If your company specializes in one medium, use the acquisition process to get you into others.

7. Increase Number of Customers

What can you do with a company that has only three or four customers? Very little. Aside from cyclical effects, you're a captive. You're not your own man. If you are in this position, you're a patsy for every fancy and foible of your limited market. Use the acquisition process to substantially broaden your customer base. And it's always great if they want to buy your other products (but that's a Supplement).

8. Increase Shelf Clout

Another textbook item. If you have only two items that sit together on a supermarket shelf, you don't have much "clout." You simply can't get the shelf space allocated to you. But as you increase the number of items in your line, you can demand—and get—more and better shelf space. That's known as "shelf clout."

9. Full-Lining

One of the great merchandising miracles of the Fifties was Hewlett Packard's successful attempt to put a full line of electronics test bench equipment in the hands of the electronics experimenter and technician. Before, each man on a bench had some eight or nine pieces of equipment each made—and well made, mind you—by a different manufacturer. Hewlett Packard started with a fairly good voltmeter, added frequency standards, scopes, etc. They looked alike, they hooked together, they could be serviced by the same serviceman. And Hewlett Packard ran away with a large part of the market. They had decided to "Full-Line It!" This is an important concept in thousands of different industries and may be a powerful reason for making an acquisition if you don't have a full line.

10. Bundling

Bundling is the process whereby you add an item to your line and then sell both as a single package. While IBM had to "unbundle" (or appears to have unbundled), bundling is an important concept and, where legal, can be very profitable.

11. Second Lining

You have a product selling at $100 on average. To foreclose the market to others, you make a second item to sell in competition with the first at a slightly lower price. It could be the exact same item with the labels or colors changed. Or, as in the case of Hot Point, G.E.'s second line, it could be quite different. Before you bring out a new item, it might be well to look around and see what might be available to acquire out there now—*before you start up*. After acquisition, bring out the new item and let the two fight it out in the marketplace. (There are even advocates of third-lining, but that's a bit dicey except in laundry detergents.)

12. To Meet Functional Competition

If you're in the linen supply business, and paper products are being constantly improved to the point that they are more and more acceptable, sooner or later they will invade your market to the extent that they threaten your survival. Before that time comes, be reminded that it's better to "Join 'em than to fight 'em." But join them early, at a low price. Keep your ear to the ground and make a note every time one of your salesmen loses a sale to a competing material or function. When the stack gets annoying and ugly, acquire!

13. To Offset Anti-Social Image

Many companies in the United States have a bad image with the public. Further, there are all kinds of "social action" committees and investment committees that simply will not invest in the securities of companies they believe to be "socially irresponsible." Companies in this situation may be able to use an acquisition to improve their image.

A case in point is Dow Chemical Co. There are hundreds of thousands of homes in the United States where no Dow products are allowed—among other reasons for Dow's stubborn defense of their manufacture of Napalm during the Viet Nam War. Just as we go to press, an AP story says they are cancelling their support of research activities at Central Michigan University because Jane Fonda criticized Dow while speaking there. Dow President Paul Oreffice, promptly flew into a pet and cut off Dow funds going to the University, thereby making headlines all over the country and adding another hundred thousand households where Dow products are persona non grata.

REGULATORY AND LEGAL

1. Public Utility Effect

This is a peculiar item. Ask any executive of any regulated company and he'll tell you that he wants to "get out from under regulation." You ask him "Why, aren't you making any money?" He dissembles. He has no answers.

The concept of the Social Contract began when man first came down out of the trees and traded away to the State his right of free action in order to obtain the protections afforded him by the State. It's exactly the same with the public utilities. The author has recently had many natural gas companies in attendance at his merger seminars. They know that in 12 or 15 years they'll be out of gas. What will they do with the hundreds of millions of dollars of assets that they have accumulated under the protection of the State? Liquidate? Hell no. They want to get into the grocery store business. But the only thing they know how to do well is to operate in a regulated environment. They should be out buying water companies (which in a few years will be as important to industry as is natural gas today).

So if you're regulated, here's where you put in "Non-regulation." And if you're non-regulated and would like to make money in a protected market, i.e., if you want a legal monopoly, put down "Regulated." (Naturally, there are many kinds of businesses that are not public utilities but which are regulated—like insurance companies.)

2. Concentration Potential

There are hundreds of industry sub-groups that are highly fractionated, and new ones are constantly being formed. One of the reasons for effecting an entry into a new industry is the fact that yours is concentrated—that is, the four-firm and the eight-firm ratios exceed the

BEST ORIGINAL AVAILABLE

Department of Justice's Guidelines and you are not permitted to make significant acquisitions in your present field. So, while you're at it, you might as well pick an industry that is unconcentrated or "fractionated," where you can make a series of acquisitions without having the Department come down on you.

3. Tax Shelter Potential

Not really a textbook variable, but while you're making acquisitions, you might as well hunt up some tax shelters—not only to shelter the earnings of the acquired company but your own as well. Without regard to the *morality* of the search for shelter, numerous court decisions require the directors and officers of a corporation to show due diligence in the investment and the protection of the stockholders' mite. This reponsibility certainly could be extended to the proposition that sheltering earnings from the tax collector is part and parcel of due diligence activity.

A rule of thumb: If your tax rate is over 44 percent, if you have foreign-based income or can generate it, and if you are in a capital-intensive kind of business, this variable should be considered.

4. Patent Protection

If you have no patent protection on any of your products and processes, perhaps you can change that by an acquisition. After all, the Constitution itself saw the need for protection from competition in the form of a temporary monopoly awarded to inventors individually and to the corporation as successor. If you are of the mind that "there are no protections in patents," you are wrong. Some of the greatest industrial fortunes of all time were built based on the generation of patent protection.

So, the complementary entry for lack of patent protection is to acquire a company or enter an industry that has some. Perhaps you can hitch an acquired patented product to your unpatented product.

5. Technology Transfer Potential

While on the subject, consider the *technology transfer* phenomenon. The United States has burned up most of its oil (yet it consumes some 40 percent of all the oil consumed in the world); it has dug up most of its gold, iron ore, lead, and zinc; and it is rapidly depleting its uranium ores. But no matter. As a "have-not" nation with respect to natural resources, we are a "have" nation from a technological standpoint. Ninety-five percent of all of the world's technology is resident in these United States. If you have no technology for sale, make an entry that does. Over half of all future earnings of American companies might stem from the sale and rental of technological information! (While the author is less certain of the following variable, it might be that, eventually, management technology will run it a close second.)

6. Management Systems

If you don't have a management system, buy or merge with someone who does!

7. Trademark Protection

What an advantage to have a trademark that you can use on *all* of your products! If you don't have a readily recognizable trademark, it may be important to pick one up. Again, there are literally thousands of famous trademarks that can carry *anything* along. Many are owned by deadhead companies that are going nowhere in a rush. So buy them up, lay the mark on your products, and watch the action. Enter an industry sector where marks are important.

8. Copyright Protection

Not in the same genre, but if you have no protection at all by the copyright acts, you might consider gaining some protection for your earnings stream by investing in a company that has long-term copyright protections. There might be some special reasons for this. Some nonprofit institutions that have a long-term investment base—say fifty years or more—might find it beneficial to acquire companies that have fifty to seventy-five years of potential royalty flows.

9. Technological Know-How

Investment in technological know-how is risky—especially undisclosed know-how—but there are some that believe in it. The problem is that undisclosed technological know-how can be 99 percent junk—it is undisclosed because it is worthless. But for those that believe that all of the best patents are "kept off the market by General Motors and Standard Oil," here's where you put your bets.

10. The Non-Union Entry

Finally we come to one of the most popular Complements which has its expression in "How do I get away from the union?" Many points can be entered here for a firm that has had a history of continuous labor strikes.

An old labor lawyer and an old employer, faced with a union organizing drive, had lunch together. The employer says: "Thank God the union is coming in. I'd much rather deal with one man about raises than deal with 2,000. But I can't let them know how much we need them or they'll really hold us up." The lawyer says, "Trust me, they'll never know, but you might have to stand a strike."

So, strange as it seems, you might take this item and turn it around. An unorganized company might enter the Complement "Union Organized" as a desirable thing. On the other hand, if you have a bad union, you might be able to trade it in for a good one through a merger.

OPERATIONS

Finally we get to operations and we get a chance to pick up some synergies. What might they be?

1. Purchasing Clout

A plan for 100 percent expansion by horizontal integration and market extension will yield substantial benefits if you move vertically backward first—buy a supplier and double his sales. But even if you do not move backward and buy him, such an expansion will give you added clout with your suppliers for you may double your purchases from them. This means that you might be able to get not only lower prices, but better credit terms, better quality, faster delivery. You might trade that out before you make your expansion moves; it is not unknown for suppliers to help finance an acquisition that will give them added sales.

2. Customer Clout

This is a different kettle of fish and depends on the structure of the industry. But expansion by the Market Intensification Mode, where customers are widely spread such as in suppliers to a supermarket chain, changing from a "regional" to a "national" might enhance your status as a supplier because of the savings you can effect in advertising and distribution. These savings can be passed on to the customer and will result in more business.

3. Service Efficiencies

In this world of complex devices, expansion in all modes can return great dividends if service is one of your prime costs or a significant portion of income. With seven rather than three pieces of test equipment on the bench, with 6,000 rather than 2,000 pieces of equipment to service in the same geographical area, with regional rather than national service centers, enormous savings are possible. In addition, the interrelation of service and sales can be immensely important.

The first thing that is asked of a salesman of a piece of data processing gear is not "How much is it?" But, "Can we get better than the standard nine-hour service?" So, buying a competitor builds your base. Buying a supplier insures better parts and better controls on quality. Buying a customer means you can get business because you can give him better service. Making a product extension means more instruments on the bench and better and more efficient service. Market extension and free form extension mean more products in a wider geography. So if you are service-dependent or service-oriented, this is the place to pick up points.

4. Reduce Operating Costs

No matter what kind of a move you make, will it reduce or will it increase operating costs? We're talking right now of direct costs rather than overhead. While there is some duplication between this item and the three previous items, will the move result in savings?

A case in point is the West Coast manufacturer of specialty electrical distribution equipment that developed its own over-the-road transportation system because of a history of damage experienced using the locally franchised trucking lines. At $6.5 million annual costs, the manufacturer was back-hauling empty from their principal markets in the East. They looked for a company in a similar industry whose principal markets were in California. They found it, bought it, and paid for it with the savings in transportation alone! In order to cash in on this item, you simply list your operating costs by their dollar amounts and judge every entry by its potential for saving. There are choices to be made as to whether the entries are made as "Complements" or "Supplements," but so long as they get entered *somewhere* the analysis will be correct.

5. Reduce Overheads and Burdens

One of the great myths of the merger movement is that there are savings to be had from the elimination or reduction in overheads. For most acquisitions, this is not true. It costs money to administer an acquisition even if it's across town! It costs money to set up and to administer the controls so necessary to a successful acquisition. The general rule is that you add from 1 to 5 percent of the sales dollar to cover headquarters costs, and then try to get it back out of reductions in other costs.

Generally, you won't save very much by taking over accounting and payroll functions. Moving from a regional accountant to one of the Big Eight can cost you substantially more. Perhaps you can save on legal costs, advertising costs, and costs of borrowing. However, if your overheads and burdens are higher than national norms, the acquisition/merger route *may* be the means of getting them down. But don't bank the money saved. It can prove to be illusory.

6. Reduce Financing Costs

Where borrowing money is an integral part of operations—such as in the retail furniture trade—there

may be significant advantages to be gained from expansion by the Market Intensification Mode—simply because your base will be bigger. Further, it should never be overlooked that an acquisition of a company with unused "float" is a natural. The converse is also true: if you have unused float, buy a company that needs it. The problem is that most acquisitions made to ease financial strains have only this one fit and the acquisition is in trouble from Day One simply because there are no other Complements or Supplements.

7. Inventory Reduction

It's obvious that if you buy a customer you will be able to adjust your inventory position so that you float on his orders. In times of tight money, this can double profits. Moving backward you can generate the same advantages. So, if you have inventory problems (and who doesn't? even XYZ always has a few engineers sitting around with nothing to do much of the year) that are major, look to an acquisition to reduce the cost of carrying it.

General Sources of Variables

That completes the basic laundry list of Complements. There are probably others, and there are thousands of ways to call them. The above have been gleaned from some 28 formal Fit Charts that the author has constructed in his consulting work. In addition, the author has put nearly three thousand people through his seminars where he has taught the Opportunity Wheel and Fit Chart Method of planning and those inputs also have been considered, synthesized, and entered.

About Financial Variables

For the "bottom-liners," it is possible to add characteristics that are not in the previous list. For instance, many Fit Chart sessions start out with the verbalization "We should make more money." But that entry by itself is no good. It must be restated in terms of Return on Capital, or Return on Investment, or even, as the author insists, in breaking ROI or ROC into its elements in accordance with the well-known equation: $\frac{S}{C} \times \frac{P}{S} = ROC$, where S = annual sales, P = profits, and C = whatever is decided on to represent capital. (For some, capital = net worth; for others, capital = assets in order to de-leverage the results.) The complementary entry for a firm in the service industries with a 2.5 to 1 sales-to-capital ratio is to make an acquisition at 5 to 1. But such Fit Chart entries create difficulties and generally should be handled as a pricing consideration instead. On the other hand, you should make the Fit Chart your own way. The particular variables should be chosen by mutual agreement among the people creating the strategy and whatever they understand is far better than picking items out of the foregoing laundry list unless they are right to the point. Further, the language is important—it must be couched in terms that the participants understand!

SUPPLEMENTS

As discussed before, Supplements are strengths that can be utilized in an acquisition or merger. What is your company exceptionally good at? What do you have that is unique? Where does your profit really come from? Which one of those opportunities out there can *use* your talents? Which of your assets is unexploited? Do you have spare plant and equipment?

HUMAN RESOURCES FIT

1. Board Members Fit

Why not buy a company in an industry or in a geographical area that is known to at least *some* of the board members! Imagine the risks of making a major acquisition in West Africa without *someone* on the board who has *some* knowledge of the peculiar nature of investment in that area! Or turn it around. You have on your board three members who, it so happens, have experience in natural resource exploitation in West Africa. Wouldn't it be important (or at least of some importance) to exploit that knowledge? Shouldn't an acquisition or an investment in a company with a significant part of its income stemming from natural resource exploitation in West Africa get a few points in its favor because of that knowledge? We think that this kind of an approach is necessary to good merger/acquisition planning.

But why start with the Board of Directors? A few years ago, pre-Watergate, it was not as important as it is now. Today, this writer (who is also the Editor and Publisher of *Directors & Boards, The Journal of Corporate Action*) is very conscious of the fact that board members must be much more involved in decisionmaking. This is not only because better decisions result thereby, but by the workings of law, they are more and more exposed to liability if they do *not* get involved. They must show increased "due diligence" in the protection of the stockholders' interest.

Suppose a company decides to go diamond mining in Africa because it "looks good," but no one knows anything about diamond mining or Africa and no one takes the trouble to educate themselves. When the investment turns out to be a lemon, the directors who approved the merger *may be held to be personally liable for the losses by failing to show due diligence in the protection of the stockholders' interest*. And, insurance against such liability is very difficult to obtain at reasonable prices.

Let's face it, the day of the rubber-stamp board appointed under the Old Boy system is as dead as yester-

day's souffle. There must be *reasons* for a merger. Board members must understand what the company's getting into, or the company stays out of it.

2. Top Management Fit—Line

The writer insists that top management, along with the Board, must know at least *something* about the industry that is to be entered. How important in-house management is depends on the industry and the importance of top management decisionmaking. The *style* of management is also important. The surest way in the world to screw up an acquisition is to impose an unsuitable management style on it.

The *kind* of people that are involved is also important. Taking nothing from either, let an investment banker, tired of the whims of the marketplace, decide to invest his excess funds in a race track. While many will hold that both are in the business of helping people to gamble with the certainty and the percentage of loss about the same, an investment banker has no conversational common ground with a racetrack owner. The result is a permanent communications gap. How can good management decisions be made in such an atmosphere?

Another example involved a client of the writer, one of the largest textbook manufacturers in the country. They had been loaded with cash and had made a series of acquisitions outside the textbook industry. Not one of them worked and the writer had to help sell them off. In every case, acquiror and acquiree did not speak the same language. The statement, "I don't care what they make or what they do so long as the bottom line looks good," is an invitation to trouble.

Another case in point might be made with the Princess Lines deal. Owned by Stanley MacDonald (a friend of the writer), it used a chartered ship to carry vacationers up and down the West Coast—Alaska, Vancouver, Seattle, San Francisco, Los Angeles, Acapulco, and sometimes through the Panama Canal to the West Indies. The little company had a staff of about 28 people, sales of about $6 million, and profit (all tax-sheltered) of about $1 million. Stanley sold it to Boise-Cascade in the middle of that company's big growth. B-C thought it could run anything. The staff was increased to 78 people and, within a year, the sales were still $6 million and the *losses* were about $1 million per year!

Management *style* in the travel business is quite different from management *style* in any other business.

3. Top Management Fit—Staff

If your business is staff-dependent, find an entry that is also staff-dependent—one where market analysis, accounting, engineering, quality control, or finance are important rather than one where hard-driving, executive decisionmaking and quick reaction capability are the key to profits. Before you make your move, make sure that you know the capabilities, especially the unused capabilities, of your staff people.

General Electric has, for years and years, tried to enter the educational field, an industry that depends primarily on the inputs of staff people. They have never made it and probably never will. The reason is that GE is primarily line-oriented, as are most manufacturers. This may also be the reason that GE, RCA, and other hard goods manufacturers never made it in the computer business which, like education, is primarily staff-oriented. The way the equipment is *used* is far more important than the way that it is *produced*. A television or a toaster has only one use, while computers have many.

4. Middle Management Fit—Line

Most of the foregoing applies equally to all line management. Take your total sales dollar and then allocate costs of these categories. If at all possible, find your way into a business where the cost allocation is about the same. Further, make sure that you know what your middle management people are good at. Buy into an industry that can tap that knowledge—especially if your present operations are not exploiting it to the maximum.

5. Middle Management Fit—Staff

Here, again, it is not that you are going to use your middle management to actually run any acquisition (though this happens in about one-out-of-three acquisitions), it is simply a question of what they are familiar with. And this can be very important.

Take the case of a public utility that has a legal department of 60 people. In-house legal costs run about 5.0 percent of all costs. They buy into a non-regulated industry where the in-house legal costs are 0.5 percent. Now you know that the legal costs are going to rise toward that 5.0 percent—and that may be the profit! There just is not a "fit" between a public utility where all of those costs can be passed on to the consumer and one where they cannot.

(There are also problems with rate-setting because a public utility may not be able to recover its real costs once it moves away from the regulated sector. This also applies to companies whose only source of income is government contracts. Let them make an acquisition and enter commercial markets and the fight starts. Regardless of the expense to the government, it will audit like it never audited before in order to shift as much of the G&A as it can to the commercial enterprise. Even isolating the plant and its operation does not isolate it from inquiry. This caveat applies to all kinds of costs—not only the cost of people.)

6. White Collar Fit

Most of the foregoing applies as well to White Collar Fit. Take the case of an insurance company with several hun-

dred highly trained people handling thousands of special inquiries daily. Management is skilled in the hiring, the training, the "management" of this important resource. They should find their way into an industry having this same characteristic. But simply counting bodies or taking the labor cost relationship to the sales dollar can be misleading. For example, take the case of a white collar staff maintained by a vending machine company for the purpose of counting a half million dollars per day in coins. While it is important to select fast, honest workers, they can be trained overnight—not at all comparable to the training of a clerk in an insurance company that might take six months.

7. Blue Collar Fit

Here is an item that usually generates serious problems in making a Fit Chart as preliminarily explored on the Complement side. It usually involves emotional issues of considerable proportions. As previously discussed, even the most successful companies, with the best labor relations records often want to "get away from the union." But they're successful *because* of the benefits that can be derived from a partnership of a good union dedicated to getting the best break that is economically possible for its members, and a company that believes in the dignity of the human being and is willing to sit down and bargain honestly to share some of its benefits with its blue collar employees. Never forget that it is this partnership that has made the United States the envy of the world, for nowhere else is labor as productive as it is here.

Why then, is the desire "to get away from the union" so widespread? It comes up time after time as one of the prime Complements, while companies want to leave it out on the Supplement side—even in that case where they had not had a real strike in *forty years*—a couple of minor "job actions" as they call them today—but never a real strike.

The writer thinks he has the answer. It's strictly "country club" talk. They're *expected* to talk that way. The modern executive is *expected* to "hate the union." Even if you love and respect every one of your employees, yes and even admire each of them for the marvelous things that they can do with metal, and cloth, and wood, and what-have-you, it's still a game that executives play. It may even be a very necessary game for both sides to play out.

It is also Board-of-Directors talk—which, for many companies, is the same as country-club talk. It's just proper pre-meeting conversation. If so, it shouldn't color the truth when it comes to investing the stockholders' money in a new venture. *This is the real world now!* Take a good look at your company. If you have trouble in being objective, hire a consultant. Let him analyze your ability to manage blue collar skills. Find out if they're an important or major part of the sales and profit dollar. If you've got a good record in labor relations, see if you can find an industry where they *have* labor troubles! Enter cheaply and rebuild the relations with the workers and the unions. That's the way to make a killing!

PHYSICAL RESOURCES FIT

This involves a company's physical facilities and the functions that go along with them. There are probably twenty different headings that could be entered here, but the author has reduced them to three.

1. Plant and Office Fit

The first variable is "Plant and Office Fit." There are really two questions: How important are "plant" and its operations to you? What do you know or have that is special? And second: "Do you have any spare capacity? Can you put spare plant to work by making an acquisition?"

One of the quickest ways to go bankrupt is to create make-work activity for an idle plant (or idle men for that matter). But if you're stuck with it—you can't sell it off or rent it out—perhaps an acquisition is the way to go. Just make sure that it *fits*. This usually requires some kind of a checklist to make sure, because even an insurance policy change can be a big, and usually an unexpected, item. But it can go either way; you may save a bundle on insurance!

Depending on the relative costs and contribution to overhead, make sure that the office operations that you acquire "fit" if transfer is contemplated. It would be unusual for this item to be of sufficient importance to bar an acquisition, but there are some circumstances where it becomes important. Can a chain of real estate brokers specializing in residentials really merge with a chain of insurance brokers and merge the offices? Can they, in fact, realize the economies so blithely predicted for them before they actually tried it?

2. Equipment Fit

Again, you don't buy a company to put spare equipment to work. You sell the equipment off. However, if you're really stuck, an acquisition may be the way out. But make sure that there is a fit.

Example. An automatic screw machine company bought another automatic screw machine company. The buyer was loaded with work while the other was dying for lack of it. But (can you believe it?) no one checked the size of the hole through the spindles of the no-work plant! They were useless for the main purposes of the purchaser. After only six months, the plant was put-up for sale. There were no takers and its was junked—really *junked!* For to cash the loss against current earnings and get the tax credit, you have to take a sledgehammer and physically smash all the equipment and sell it for scrap value. Otherwise, you take a capital loss and can get it

back over the next thousand years instead of the next month!

3. Storage and Transportation Fit

This is an important item because the fit has to be carefully explored. Consider a pecan factory in Georgia. Pecans are picked in the early fall, then hulled and shelled, graded, stored under refrigeration, and then moved out to market beginning just before Christmas. The warehouse gradually empties and is bare again in June. Here is a vast warehouse with only a 38 percent use factor. The fact that pecan picking and processing is a highly seasonal business will show up in the Complements. The pecan factory needs to find something that will use the warehouse during the off-season. But the warehouse is used for the storage of *food*. People wear white coats. It's a spic and span warehouse. All of the materials handling equipment is designed for handling *food*. Most warehouses and much of the supporting equipment such as trucks and rail cars are specially designed and constructed for food use. Is it an impossible task to find something to fit? Difficult, yes, but it is always possible to find *something* that will fit. If it is a major item, the looking may be expensive and it might take time, but an industry entry that will put the warehouse to work can always be found.

Again, it involves Complements, but make sure that your trucks can actually carry the item on the back haul as planned. Coal can go one way and grain come back, but how about cement? If your over-the-road fleet is back-hauling empty most of the time, *you can always find an entry that will fill them*—but make sure it *fits*.

TECHNOLOGICAL RESOURCES FIT

For technological companies with a high level of accomplishment, the proper Complement might be to merge with a company that can move the product out to market and the thinking usually stops there. Of equal, if not more importance, is the "fit" of the technology which starts where everything new begins, with the research and development function.

1. Research & Development

Do you have unexploited R&D skills? Can you acquire a company in the cash cow state that has everything *but* a modern product? Can your research staff take a look at a deadhead company in a deadhead industry and come up with something that will give it new life? This is the stuff of which real profits are made. While this article is not a disquisition on the conversion of R&D to products and profits, people in every company should have the responsibility of keeping their fingers on the pulse of the company's technological state-of-the-art. They should be constantly on the lookout for places to put it. (The author is associated with Technology Audit Corporation which does state-of-the-art analyses of technology. While often an investigation will prove that a particularly expensive program will be a solution looking for a problem and may be the pet project of the President's brother-in-law to boot, there is an equally likely probability that there are unused proprietary technologies that someone somewhere needs. It is important to audit your technology and look for an industry [and eventually a company] that might use it).

2. Product Design

Here again it is important to look for fits. The success of the Japanese firms in entering world markets at the astounding rate that they have is partly due to their highly developed "design" skills. They have very little technology of their own; most of it is borrowed. But they have their fingers on the pulse of the world as to what is considered good design.

Good for the Japanese! But, as a nation, we in the U.S. are better off with the continuous generation of 90 percent of the world's technology (though the author fears that we are exporting too much of it too rapidly and at too low a price). But we are peculiarly insensitive to *design*. Much of this insensitivity stems from the arena of competition chosen by the American corporation. In the automobile industry, they choose to compete in "style," which has little to do with "design." They compete here because they can, by huge advertising expenditures, create demand for a flashy, ticky-tacky product. They choose not to compete in the area of comfort, safety, economy, or reliability. McLuhan says that the medium is the message and the fact that "the hype can move tripe" is important. (Where can they go anyway? They all play the same game!) But American firms are *very* vulnerable to good design by foreign companies. (Ever notice that families that do not have television drive foreign-made cars?)

So, if you have any design skills, if you have developed a group that is capable of designing a product that looks good and is also economical to operate, safe to operate, and won't break for a few months, find an industry where the competition is spending so much money on hype that they have neglected design. Then move in and take over! (Unfortunately, if you're good at hype, it also goes in here.)

3. Product Engineering

This is allied to the above item, but is not the same. It is important that whatever is designed be designed for easy manufacture and assembly. That calls for special skills that have been highly developed in many industries, especially automobiles. The designers drive the production engineers crazy because they are constantly

coming up with things that just *can't* be manufactured cheaply or assembled cheaply or serviced cheaply.

The point is that if you have above-normal skills in product engineering, you should cash in on them by entering an industry where such skills are not highly developed, and clean up. This is not as hard as it sounds. Go to any store and have your engineers disassemble some items. It is amazing the incredible stupidity that is built into many, many products. Consider parts simplification. Take an item that has 70 parts to assemble. Making it from 15 takes skill. You may have those skills. It may cost something in tooling, but the money comes back very fast if you can effect an entry. Always buy into backward industries, buy dum-dum companies in those industries, and modernize them. *That's* where profits lie.

4. Production Engineering and Automation Potential

The ability to identify an industry where a good job of production engineering and automation will make you a market leader may be the single item on the Supplement side offering the greatest potential for profit. There are thousands of such industries. But you must have the skills. And if you have them, put them to use by the acquisition route.

While it is not as simple as the product engineering item above—and of course they are highly interdependent—still, if you have top skills, and especially if you yourself are completely automated, you may be "over-managed" in this department. Cash in on this by making sure that you enter an industry where those skills can be put to use. (You should also note that "Automation Potential" was an early *Complement*—the theory being that if you were completely automated, or if you were in an industry where there was no automation potential, that you should look for one where there was. But this begged the skills question, and it evolved into the Production Engineering and Automation Supplement. It's just more logical to handle it here than there.)

5. Quality Control

For many companies this Supplement can be included with the preceding item. But in some industries, the two are not so carefully integrated—such as in job shops and in one-of-a-kind production operations. If you have developed top quality control systems, complicated inspection procedures, or 100 percent inspection, look for an industry where these skills can be applied. And if you don't have those skills and the industry requires them, beware, it may not be your cup of tea!

6. Estimating, Bidding, and Pricing

For some companies, estimating, bidding, and pricing constitute a large percentage of total expenses. Successful construction companies look to this area as the place where they either make or lose money. Again, if you have skills in this area, put them to work when you make an acquisition. But stay away from entries where such skills are not needed—you'll be a fish out of water.

A case in point. Proposal writing to win government contracts—where the proposal and not the price is the governing factor—is an important part of government contracting, particularly with the Defense Department. Yet I have seen company after company that was expert in getting continuous flows of government contracts emphasize in the Complement side "Getting away from Defense Contracting" (this item is also discussed in the Broader Customer Mix Complement). What you should do is look for a company that has top men, facilities, and technology but doesn't know how to produce a top proprietary proposal to Defense or to government.

7. Field Engineering

While this item could just as well, for most companies, be put under the Marketing Resources Supplement which follows, for some companies it is not. Where a skilled staff of field engineers has been built up, it may be important to exploit their skills.

8. Service

Ah, Service. Here's a Big One. Perhaps no other item under the Supplement category holds so much chance for good increases in Return on Sales and Capital. As discussed under Complements, adding an instrument to your line that will complete it is a major marketing benefit to be gained by the acquisition route. It becomes even more important if you can service this additional product with your present service organization. The savings in costs can be considerable, and the capital cost to achieve it is often zero.

MARKETING RESOURCES FIT

1. Salesman Fit

Salesman fit means, "Can the salesman carry the line?" If he takes orders every Thursday for the hotel's linen requirements, can he also get an order for their janitorial supplies? Can he learn the new line? Can he sell it? Can the Hewlett-Packard salesman, who sells the voltmeters and the frequency standards, sell the scopes? Can a large group of life insurance salesmen actually learn enough about casualty insurance to sell it? For some, by bitter experience, the answer turned out to be a resounding no.

But something can always be found that your existing sales force *can* sell. If sales is the basis of your company's success, and your sales staff is the reason that you are successful, exploit this fact by giving your salespeople more to sell. Turnover will go down as income rises.

You'll be able to get better and more productive people on the street and in the office. If you're a single-liner (that is, with only one product or service in your satchel) and you're highly seasonal or follow any kind of feast-and-famine cycle, you should be looking for a *complementary entry* that will *supplement* their income and yours.

2. Dealers and Distributors

A distribution system is difficult to set up and to maintain. In some industries, turnover is a problem. Just as in the case of the salesmen, the more lines you give dealers to carry, the better they like you. Make sure that you understand this variable. The writer consulted in the case of a pipe manufacturing firm that made no direct sales at all—everything went through distributors and dealers. The company wanted to get into the log cabin business—those pre-cut log cabins that are currently very popular. They entered some large values in favor of such an acquisition simply because the item was sold through dealers and distributors—but *not theirs.* This variable is included to give points to any acquisition where you can distribute the item purchased *through your own system.* While it might be argued that headquarters skills in knowing how to set up a network of dealers and distributors is an important resource, it should be handled under the top management, line or staff, category above.

3. Customer Fit

This resource is concerned not with whether the salesman can sell it, but asks: "Do your present customers need it, do they want it, and will they buy it?" Do XYZ's clients who are buying its mechanical engineering services have any need for docks and harbor design or for the environmental items whose manufacture XYZ contemplates? This is the key fit for any company that has a solid customer base.

The writer has always been surprised by the ratings given to this item. He has heard: "I don't care what we do so long as we get something new to sell to our present customers." And the opposite: "We don't need to find something to sell our present customers, what we need is some entirely new lines, to open up new markets." It's the Supplement vs. Complement approach. Either could be right, although certainly the Complement holds a much higher risk of failure. But perhaps no other variable under either the Complement or the Supplement side holds so much chance for profit. Find something that your present customers will buy. That's the name of the game.

4. Advertising and Media Fit

Before any diversification move is made, make sure that the entry is compatible with your present advertising plan. What can your agency handle? Ask them! How do you sell? Door-to-door? By direct mail? By space ads in newspapers? Or in the slicks? What role do the media play in the larger picture?

Remember the little camera shops that used to be all over town? Most of them are gone—replaced by the chains. So far there seem to be no national chains, but there are many local chains. In the Washington, D.C. area, for example, Snap Shops and Ritz Camera each have about 15 stores. Where did they come from? Well, they grew out of the phenomenon of suburbia, the growth of the shopping center, and were aided by the raw economics of print (newspaper) advertising.

Both Ritz and Snap Shops run a sale at least monthly. They usually take a full page in the *Washington Post* which costs them about $4,500. With 15 stores, each is charged $300 for its share of the big ad, or about $3600 per year. In contrast, for $3600 per year, the independent camera shop downtown can only afford a quarter page twice a year! They just can't hack it. They might stay in business if they convert to a "boutique," become the local "Nikon Shoppe" and sell nothing but Nikon cameras, but their chances of survival as a general camera store are near zero.

So, if you're in an industry where the annual advertising costs approach the after-tax profit, you have to go chain. That's the reason that only the large supermarkets, and multi-outlet supers at that, have survived across the country and the "mom and pop" stores are out except in ghetto areas where home economics are non-existent.

But to cash in on this effect, you have to use the same advertising medium. Additionally, an industry that has built itself by national print should stay in national print to pick up the discounts—they can pay half the price of an acquisition! If you're selling by television and radio, the discounts are even more impressive. You can pay for the whole company out of the savings if advertising costs are a large percentage of the sales dollar.

Another effect is called *shingling.* Will one ad carry two messages? Here again you can get half or all your money back from the savings in advertising costs. We have a perfect example right here in-house at M&A.

In order to get new subscribers to MERGERS & ACQUISITIONS we mail many thousands of direct mail pieces to lists that we either compile ourselves or buy from list brokers. We mail each of these potential subscribers a piece of mail that, with postage, costs us about 23¢ each. So, 50,000 such pieces costs about $11,500. Like every journal or magazine publisher, we hope to "cash out" on our mailing and get as much money back as we put out. We then get our profit in future years from renewals.

But now we also publish *Directors & Boards.* So we ask the question, "Will people who *might* subscribe to M&A also subscribe to D&B?" To test this out, we

bought a list of people who had recently bought a new and very good book about mergers. We mailed those purchasers not only an invitation to subscribe to M&A but, in the same envelope, for another two cents, an invitation to subscribe to D&B. Incredibly, we got more returns *numerically* for D&B than we did for M&A!—and substantially reduced the cost of obtaining subscriptions to our journals. This is what we mean by a "media fit" and by "shingling." On a large enough scale, that can pay for an acquisition!

5. Public Relations

If you have had success in building a solid image for your company out there where it counts, find your way into an industry that is in the opposite condition and put your skills to work!

OPERATIONS FIT

1. Suppliers

A good supplier, just like a good union, can *make* a company. Before you make an entry, take a look at your own suppliers and test whether your relations with your suppliers will supplement the deal.

To use one of your unused credit lines is a Supplement—you are employing an unused resource or asset. (Do not confuse this with the *Complement* generated by effecting an acquisition so as to use an acquired company's credit lines for which you, the acquirer, cannot normally qualify. They are two different things.) Take a look at your suppliers; they may help you finance the acquisition! In any event, as far as *operations* are concerned, your relations built up over years with a host of suppliers is an asset. Make sure that you use it properly.

2. Customers Fit

Again from an operations standpoint, can you combine shipments? Can you process the order together? Can you make pre-assemblies that will raise the prices and profits? Have you ever asked your customers if they would like you to buy one of their prime suppliers simply because they consider you a better and more reliable manager? (It is well known that the Defense Department constantly shops for firms to buy up the ones that are in trouble, though D.O.D. will generally deny it if questioned.) Ask your principal customers where they have the most trouble. Where are they going in the future? What will their needs be in the future? What could you do acquisitionwise to help them? How about a joint venture?

The test is this: what is the turnover rate of your customers compared to that of your competitors? If you keep customers significantly longer, you have a resource that might be exploited not only to your benefit, but to theirs as well. And never forget, they may be so happy to see you buy one of their suppliers, *they may finance the whole thing!*

3. Scale Fit

Scale can be entered nearly anywhere and perhaps should be entered in each of the above categories. However, it is most important when it comes to day-to-day operations. Things like the absolute difference in the number of employees, the size of the typical order, and the physical size and weight of the product involve "scale." Stay in scale if at all possible. If you are mass-producing small electrical components that sell for an average of 13¢ each, don't suddenly start making frequency analyzers at $130 each! Regardless of the marketing side, they simply don't mix—they're "out-of-scale."

The average dollar size of an order is another source of trouble. Suppose the average size of a job-shop order is $7,500 and it costs $150 to process the order—to take it in, schedule it and bill it. If the job shop buys a company that uses similar skills but where the average order is $750 and the average cost to process is $15, you can bank on it that the average cost of processing the $750 order will rise and the other won't come down one red cent! Before you make a move, make a list of the factors where scale is involved and decide how important it is to you to stay in scale.

There can be some redundancy here. Suppose that your costs for blue collar labor is 50¢ of every sales dollar. You will be out of scale if you make an acquisition at the 10¢ level. However, you may have already covered this item in the Blue Collar Fit variable. Don't count these items twice!

4. Industrial Relations Fit

Here is a good opportunity to emphasize again the importance of cashing in on any employee relations assets. It is not unheard of to take the union into your confidence in planning an acquisition. After all, an acquisition generally works out to their advantage. And you should make any necessary deals with the union *prior* to the closing. Don't close and then tell the union. You can take the attitude that it's none of their business, but rest assured, they often can and will *make* it their business.

5. Regulatory Problems

For some, regulatory problems in operations are extremely important. For others, it doesn't matter at all. Take firms with OSHA problems. Some industries can be brought to their knees by problems that you may already have solved. You may have an OSHA compliance

group that is skilled at quickly and economically bringing any kind of an operation into compliance. Why not cash in on this asset?

The same kind of thing applies to any operating variable. It's something like a football team—it's the penalties that cause you to lose the game. If you've been able to get along with the inspectors from the FCC or the FTC or the CAB (or the local Health Department, for that matter) cash in that asset.

FINANCIAL RESOURCES FITS

1. Bank Lines

Do you have unused bank lines? Make an acquisition and put those lines to work—the seller may not have them. But make sure that your bank understands the industry that you are about to enter. If not, tragedy may follow. Example: A publishing company sells large Bibles door-to-door. It takes the $48, twenty-payment contract to a bank and gets 80¢ on the dollar. It has some $3 million of such paper out. Its operations are profitable. The publisher buys a company that sells large $48 dictionaries, also door-to-door. The Bible publisher pays $4 million for the dictionary company, which also has some $3 million of dictionary paper on the asset side which they've been carrying themselves.

The Bible company makes the deal and then trots down to the bank to discount the paper. Much to their horror, they discover that, while Bible paper discounts at 80 percent because just about everybody will meet the payments on the Family Bible, dictionary buyers frequently don't pay. As a result, dictionary paper discounts at a 50 percent rate. In this case, the publisher was not stuck with the paper itself, for his purchase price was based on a guarantee as to the worth of the paper. What really hurt was that the bank cut the publisher off from further loans and called for prepayment of the loans against which the Holy Bible paper had been pledged! They were mad because the publisher had not consulted them prior to making the agreement to purchase. The publisher had to sell a large chunk of the equity in his company to get money not only to pay off the loan, but to finance the acquisition of the dictionary company!

So, mark well. A good banking relation is an asset. Treat it like one. Take care of it. Nurture it. Some day you're going to really need that bank line when you make an acquisition—especially if there is some speed needed to complete it. Make sure that it *fits*. Talk to your banker about it—early.

2. Commercial Paper Lines

How good is your commercial paper? Do you have unused capacity here? Will it be increased by an acquisition? Perhaps the deal will fly simply because the banks like the industry. Again, it could help pay for the entry!

3. Public Lines

How does the public like the industry? Can you raise the money from the public to help pay for the company either through a secondary offering, a sale of rights, or convertible debentures? And how about private placements? Do you have some unused clout on your investment banker that will *cause* him to hustle up the price of an acquisition? Inventory your resources. Will they "fit" with the new entry?

4. General Lines

There are many other sources of finance, from factors to warehousers to financial discounters of all kinds. Do you have unused capacity? Can you use the system that you have created to finance your operations to finance the new entry? Is your company particularly skilled in collecting its receivables? Can it apply this skill in other entries? Be sure to inventory all your credit lines to see if they'll fit when that entry opportunity comes along.

5. Cash Budgets

A look at cash flow patterns in your own industry and an attempt to match them to other industries can be a Complement or a Supplement depending on your own cash flow problems. Example: A ski distributor importing foreign-made skis receives most of them in August and September. His sales are about $18 million per year and he needs to borrow, at the peak, some $10.5 million from local banks. Half of the year, his entire net worth of about $4.5 million is in cash sitting in the bank in C.D.'s.

He looks for something that will use his excess cash and credit lines from February through July. That's a Supplement. But he also looks for something that has excess cash in August through January so that he can save interest charges. That's a Complement. He may be able to do this with a series of small acquisitions. Properly done, the savings could pay for the acquisitions!

INFORMATION FLOWS

1. Accounting—Internal

It doesn't seem to frighten most acquirers, but shouldn't more people be concerned with the "fit" of their internal accounting processes? The accounting rules tell us that all accounting practices must be the same throughout an organization, but that doesn't always happen right away. Moreover, there are different rules for different industries, and a lot of bad happenings can be covered up in the accounting until the acquirer is initiated into the mysteries. It's not a big point, but where there are sub-

stantial tax benefits to be cashed that are peculiar to the industry, it is just safer to stay closer to home.

2. Accounting—External

Again, this is not a big problem, but there is still controversy even within the accounting profession on how certain expenses should be treated. Take the difference between the accounting practices of major oil companies and the independents dealing with the problem of "full cost" accounting as opposed to the "successful efforts" method. Full cost accounting, in which exploration costs are capitalized and written off over future years, can increase *reported* earnings by as much as 20 or even 30 percent. There are dozens of like rules in the extractive industries and every industry has special rules and methods of treating inventories, earnings, etc. All other things being equal, it would be nice if the accounting methodology in the industry you are entering is the same as yours.

3. Budgets, Planning, Strategy Formulation and Futurology

Budgeting is a highly developed art, though you can still find billion dollar companies that don't have good budget programs and some that have none at all! If your firm has highly developed skills in this area, find a place to use them. In general, new, high-growth industries have not had the time to develop good budgeting processes, while mature companies have. If your growth is slowing and you're over-managed, find your way into a high-growth industry and put in your budgetary and cost-control systems. The same thing can be said for planning and strategy formulation.

As for futurology, what is there to say? One good futurologist can work as easily for five companies as he/she can for one. So if you have a good futurology department that's looking ahead ten or twenty years, and you have spent some money on a really solid look at "energy" or "consumer lending," you may as well cash in on it by staying in "energy" or "consumer lending." You should constantly look for fits where you have done some long-range planning for your own operations.

4. EDP Fit

Generally this means "utilization" rather than "fit." For one of the ways to pay for an acquisition is to take over all the data processing and centralize it. But compatability can be a problem. Can you hook up the field units to the new central processor? Is there sufficient bandwidth, and are the telephone lines noisefree enough to keep the error rate down? If the electronic data processing function is a major cost, all of these questions should be asked and answered prior to entry. (One major caveat. Getting rid of the acquired company's EDP installations may be like trying to get rid of crab grass. One completely frustrated CEO told me that, after acquisition, at every management meeting for the next 16 months he was told "next month." As in closing down losing operations that are protected by several administrative layers, the CEO found only one solution—cut off the funds for payroll and it *will* close down!)

5. Legal, Lobby and Trade Group Fit

Perhaps "legal" and "lobby" shouldn't be linked. But if you maintain a lobbying office in Washington or in a state capital and you are able to protect yourself against unfair legislation by your familiarity with legislative practices, this is an asset. You should exploit it.

The same things applies to all of your legal problems. If you have learned how to keep out of court because you have a highly skilled legal group, an entry into a similar field will pick up points for it in support of entry.

Further, if you belong to a trade group where it costs money to maintain a membership, acquiring within the same industry might save some money.

6. Environmental Fit

Finally, we come to a very sensitive area. If you've learned how to get along with the environment and the environmentalists, capitalize on it. Stay close to home geographically where you know the problems. One of the things that got Boise Cascade in trouble was their unfamiliarity with environmental problems in unfamiliar geographical areas. So if you know how to strip-mine coal so that the land can recover, then perhaps you'd better enter strip-mining where they don't. If you know how to treat your waste water economically, find your way into an industry where they don't. If you know how to scrub your stack gases economically (which might have cost you millions to discover), find an industry that has not yet solved their stack gas problem and go in and take over. There must be *reasons* for a merger or acquisition, and out of the big push for control of environmental decay comes opportunity.

Next issue

That brings us to the end of the Supplements and the end of the introduction to the Opportunity Wheel and Fit Chart Constructs. You still have not learned how to use all of the variables, how to weight the variables and select out the ones that really matter, how to rate the various entries and establish the rank orders.

That process that will be the subject of PART III.

After that, we must discuss mounting search programs to find companies, run *them* through the Fit Chart and then go through some decisionmaking process to acquire them. ■

M&A

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WHARTON REPROGRAPHICS

Risk Management

Spotting the Warning Signs Of Product Liability Woes

Charles J. Israel

A buyer never can be fully assured that an expensive product liability devil won't jump up after completing an acquisition. But solid, in-depth investigation using established techniques can head off at least some serious problems that may be brewing at the time of the deal.

CONTROL OF PRODUCT LIABILITY issues that arise from a company's existing operations is a complex challenge to every corporate risk manager and in-house attorney. Dealing with current damage claims and engineering safeguards to prevent known problems represent just one dimension of difficulty. Even more vexsome is projecting whether the use of the products or materials will cause future injuries or illnesses that could expose the company to liability. Imagine, then, how the issues compound in an acquisition when the time to intelligently assess a target's product liability potential is short, its business may be somewhat different from the acquirer's, and a large up-front investment is on the line.

But any buyer that closes a deal without trying to evaluate a target's product liabilities may be blindsiding itself. Future claims from problems that are known or have yet to surface may be so enormous that they can destroy the economic value of the acquisition.

And the stakes for acquirers have risen. Product-related litigation is increasing and recent court decisions have saddled acquirers with liabilities for products made by targets or their predecessors many years earlier. (See "The Dangers for Buyers in Flawed Products," *Mergers & Acquisitions*, July/August 1989). New types of injuries and illnesses constantly are being discovered, and hazards as yet unknown can haunt acquirers that buy targets on the leading edge of advanced technology. Moreover, many of the most active m&a industries — such as drugs and other health care products, chemicals, metals, machinery, and electronics — are highly prone to product liability exposures. How, then, does a wise buyer protect itself from the shocks of product liabilities?

The answer lies in a relatively straightforward three-step analysis that should be undertaken in connection with virtually every transaction that involves some measure of actual or potential product liability exposure. First, the nature of the actual and potential liabilities must be defined. Second, the potential liabilities must be evaluated to determine the true extent of the problems that may exist. Third, the risks must be assessed in terms of their potential impact on the transaction itself or on the future of the business.

As the first step in defining the risks, the buyer should be satisfied that the purchase agreement

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itself contains adequate protections in the product liability area.

The provision in the purchase agreement that defines the nature of the pertinent risks and liabilities is the "representation and warranty." That section should include within its scope matters relating to product liability. A litigation representation, for example, generally will state, among other things, that there are no lawsuits pending against the target company beyond those specifically enumerated in the purchase agreement.

However, more may be needed than general assertions. A pure litigation representation that does not specifically address product liability concerns may not always provide adequate assurances to the buyer because it may not cover pertinent details that fall short of actual litigation. Among other things, these issues would include product recalls and retrofits. The particular circumstances of a target, therefore, may require explicit recitations with respect to product liability matters.

A representation by the seller serves to provide the purchaser with a degree of certainty as to what it is buying. It places the onus on the seller to disclose all pertinent information. The ball is, therefore, in the seller's court to ensure disclosure. Otherwise the seller is susceptible to a claim for breach of the representation or, even worse, for fraud. Representations, together with other provisions of the contract, also may provide the buyer with some measure of recourse in the event that the representations prove to be inaccurate.

Beyond the basic agreement, there still is a need for the purchaser to investigate the risks disclosed by the seller. The representation really is no more than a safety net in this regard and cannot provide complete solace to the purchaser. There can be no truly effective substitute for actively investigating product liability matters, which can be as important to a transaction as other general business or environmental issues.

Late in the game

Unfortunately, product liability concerns all too often are overlooked, not given the credence and attention they rightfully deserve, wholly ignored, or, as often as not, forgotten until the last minute. Given the aforementioned perils, those are foolish courses. Nor should a buyer delude itself that the size of the deal is so great that no product liability matter could have a material impact on the target or the transaction itself. There has been a major increase in the incidence of large companies with colossal product liability problems that threaten the continued viability of the business. One need only look as far as the Chapter 11 proceedings arising from Dalkon Shield litigation against A.H. Robins Co. and the bankruptcy cases involving at least five asbestos product manufacturers, including Manville Corp., in order to see the actual and potential magnitude of the problem. And even if corporate existence is not threatened, these problems divert management's attention from running the company and ultimately have an adverse impact on the bottom line.

What areas, then, are properly the subjects of the preacquisition "due diligence" investigation into product liabilities? And how should such an investigation be conducted? Although not intended as an exhaustive list, the following is offered, by way of example, to demonstrate the variety of subjects that should be addressed. (Although outside the scope of this article, matters pertaining to insurance coverage for the target company are frequently of equal importance in evaluating product liability concerns and, therefore, should not be overlooked.)

> A seller may list 10 pending lawsuits, but the loss run may reveal a greater number. While the discrepancy may not always be of great significance, it provides an indication of the seller's thoroughness and may reveal telling omissions.

The first logical question is: What type of product or products are manufactured by the target? Naturally, some types of products tend to create greater risks of harm than others. Carcinogenic chemicals and industrial machinery are obvious examples. The likelihood that harm will result from the product, and the severity of the injury, largely will determine the depth and scope of the subsequent investigation.

It should be kept in mind, however, that a substantial number of relatively minor injuries also can create large problems, from the standpoint of litigation management and defense costs, as well as from a liability perspective. Cosmetic manufacturers and food companies seem to experience a large volume of claims involving minor injuries and a large volume of nuisance claims. While the number of claims may amount to only a small percentage of unit volume of sales, the management of these claims can be a burden to a company.

A profitable source of information concerning the product and any litigation involving the product is publicly available information obtained from searching legal data bases and topical litigation reports. Inquiries along these lines not only should focus on the specific company and its products but also on other companies in the same or similar business.

As the first step in defining the risks, the buyer should be satisfied that the purchase agreement contains adequate protections in the product liability area.

Company loss runs always should be reviewed to the extent that they are available. A review of loss runs covering several years of claims history sheds important light on the number of claims experienced, the costs incurred in defending lawsuits, and the amounts paid to settle or otherwise dispose of them. This provides the acquiring entity with some indication of what its costs in this area are likely to be in the future. This review also provides a useful check on the seller's completeness in disclosing the existence of pending lawsuits. For example, the seller may list 10 lawsuits that are pending against the target, but the loss run may reveal a greater number. While the discrepancy may not always be of great significance, it provides an indication of the seller's thoroughness and may, in fact, reveal telling omissions.

Loss runs that reveal the product involved and the type of injury also may provide insight into whether a product is involved in an inordinate number of incidents. Such experiences may be indicative, for example, of a design flaw in need of correction and/or that a product recall is warranted. Particular attention should be paid to any case in which punitive damages were assessed against the company.

Loss runs are listings of claims pending against a company, typically prepared by an insurer, showing certain details of the claims including the type of product and injury involved, how much has been paid to defend the claim, and amounts paid in settlement or in satisfaction of judgments.

Unfortunately, a review of loss runs may not be enough. One specific instance that showed the inadequacy of relying solely on loss runs involved a selling entity that disclosed two product recalls to the buyer. Recalls are not listed on loss runs. In reviewing actual litigation files, it became apparent that the seller had considered conducting a recall of another product but had rejected the idea because of the "adverse publicity" that would accompany the recall. When this discovery was brought to the attention of the seller by the buyer, the seller suddenly revealed the existence of several other proposed or actual recalls that had not been previously disclosed.

Careful scrutiny must be given to the subject of product recall, retrofit, or post-sale warning campaigns. An investigator also should determine whether the company is considering to conduct a recall or similar program or whether the company previously has considered and rejected the idea of conducting a recall.

A retrofit can be part of a recall. A recall involves actually seeking the return of the product to the manufacturer for repair of the product or repair or replacement of part of the entire product. A retrofit is the repair of the product or replacement of parts, and does not necessarily involve a recall. It could be a field retrofit in which the manufacturer sends representatives into the field to perform repair or replacement work.

Concern and organization

To be sure, even the tightest due diligence provides no guarantee that a buyer will uncover all of the skeletons lurking in the corporate closet. Generally, available time is short, and that tends to impede the thoroughness of the task. A more difficult problem may be the reluctance of the target's employees to be totally candid in responding to inquiries for fear of reprisal in the event that the deal does not go through. Nevertheless, an acquiring company, armed with the right approach, generally will succeed in ferreting out the major problems.

A series of questions then must be drafted in order to properly evaluate the risks revealed by the due diligence investigation. These questions relate to many aspects of product liability concerns, and the answers will tend to shed useful light on the subject of the investigation. Among these questions are:

Does the company evidence a sufficient degree of concern about product liabilities and is it properly organized to deal with product liability issues?

Many companies devote little time and effort to minimizing product liability risks and exposures. They also may have little in the way of an organizational structure that is properly geared toward eval-

uating risks posed by products and effectively managing product liability-related litigation. The acquiring company can be well served by evaluating these aspects of the target's business.

An adequate concern for product liability matters may be seen in the existence of written company policies pertaining to such issues. This would include a written recall policy which sets forth the methods for conducting a recall and delegation of responsibility for seeing that the recall is properly conducted, claims/litigation management policy procedures, and quality assurance and quality control policies and procedures. This adequate concern also would be evidenced by an organizational structure that could include the establishment of one or more committees responsible for various aspects of product liability matters, including committees to evaluate the safety of new products before they are placed into production.

Are there product liability risks that have yet to surface or become fully apparent because of the nature of a particular product or because the product is relatively new?

Many products have the potential for causing harm that may not manifest itself for some period of time following exposure to the product. Similarly, the company's experience in manufacturing the product may be of such a short duration that it is too soon to fully appreciate the potential for harm. Conversely, a product that has been manufactured for many years and possesses a fairly long useful life may begin to experience a higher failure rate the longer it remains in use.

Recalls, if not properly conducted, can expose a company to serious liability problems. Likewise, the failure to conduct such a program can lead to monumental problems in the future.

Products that may cause future harm would include substances such as chemicals, drugs, and other materials such as asbestos. Injury may become apparent only after many years of exposure to the substance and, in the case of at least one drug, DES, injury may manifest itself only in later generations. Products that may experience a higher failure rate as time progresses would include machinery that becomes less reliable with age and consequent deterioration, and machinery with safety devices that may be removed over time.

If a recall or retrofit program has been conducted in the past or is currently underway, has the program been adequately conducted?

The results of the investigation may indicate that a recall should have been conducted in the past and was not, or that one should now be conducted. Recalls, if not properly conducted, can expose a company to serious liability problems. Likewise, the failure to conduct such a program also can lead to monumental problems in the future.

The adequacy of a recall is judged by reference to the severity (degree) of harm that the defective product is likely to cause and the likelihood (risk) that the harm will, in fact, occur. The greater the degree and risk of harm, the greater the burden on the manufacturer in conducting the recall. A thorough recall must involve determining how many units are involved and where they are located, making appropriate efforts to identify and locate the products, impressing upon the public the importance of returning the product, and keeping an accurate accounting of all products that have been successfully recalled, repaired, or replaced.

Knowing what the current product liability situation is for a target company and what is likely to be in store quite obviously may affect the ultimate decision to purchase, the price to be paid, and the negotiating stance taken with respect to representations and warranties. The less known, the more important the representations become. But even iron-clad, exhaustive representations can be illusory if the proceeds of the sale are not traceable by the time a breach becomes apparent. If a buyer is looking for recovery from the seller, it may be that the seller is no longer in existence and the proceeds of the sale have been passed on to stockholders.

Moreover, in actual practice, representations may not always survive beyond the closing date or survive sufficiently beyond the closing date to provide much protection. For example, the buyer may find it useful to have the seller indemnify it for future liabilities. But if the buyer purchases the stock of the seller or the target is liquidated following an asset sale, there may be no surviving entity to provide the indemnification should it come due. In any case, indemnifications invariably are difficult to negotiate and can become deal killers. And in a corollary to the often-slipshod investigations into product liabili-

ties, the buyer may pass up indemnifications altogether because none appear to be necessary when the deal is consummated.

A seller gets skittish

In one instance, a buyer temporarily put off the signing of the purchase agreement because it could not satisfy itself that a pending recall was being adequately conducted. In discussions with various engineers of the seller, the buyer could not get a consistent response to inquiries regarding the nature of the problem that had brought about the decision to implement a recall, how many units were involved, or how many products actually had been recalled. Because of the potential severity of injury involved, the buyer deemed it prudent to postpone signing until the matter was clarified to its satisfaction.

The precise nature of the transaction that is contemplated and details of the purchase contract provisions naturally will impact the extent of due diligence that is required. The nature of the information gleaned from the investigation also may have an impact on the structure of the deal or provisions of the purchase agreement. Thus, for example, while it may be the purchaser's original intention to assume all past and future liabilities of the target, the information acquired during due diligence may convince the buyer that no liabilities should be assumed at all or that some allocation of liabilities between buyer and seller is appropriate.

Even when the buyer does not intend to assume any liabilities, it may be important to consider the possible applicability and implications of successor liability principles. Under successor liability principles, an acquiring company may be liable to third persons for the acts of the acquired company or its previous owners, even though the buyer had no intention of assuming such liabilities.

The foregoing, to reiterate, is not intended as a thorough explanation of the analysis required in a product liability due diligence investigation. Rather, it is meant to demonstrate the variety of matters that need to be considered. The main point to remember is that virtually every buyer should have at least some product liability analysis performed, even if only to confirm that no problems exist or are likely to surface down the road. ■

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WHARTON REPROGRAPHICS

EDWARD R. MORAN

10. Screening Potential Acquisition Candidates

I would like to approach this subject of screening potential acquisition candidates by assuming that in your particular company you have established a growth plan which includes an acquisition program for the purpose of implementing such plan.

I wish to emphasize the point that an acquisition program is merely a means of implementing your growth plan.

BROAD GUIDELINES

To bring an orderly procedure out of the perhaps somewhat typical situation of flying by the seat of your pants, most of us believe that the acquisition program should establish certain guidelines or specifications in screening potential candidates, otherwise much of your time and effort will be dissipated in trying to trace down leads that actually get you nowhere.

What are the purposes of such guidelines? First, to screen out the less desirable candidates, and second, to try to determine the merits of potential acquisitions in light of corporate objectives.

Note: Mr. Moran is Vice President-Acquisitions of The Bendix Corporation. He was an executive with the Finance Committee of Hunt Foods & Industries, Inc., and previously served as General Counsel and Vice President for International Operations of the H. K. Porter Company, Inc.

Major Categories

What are ideal specifications of a potential acquisition candidate? These can be just about as many as you wish, but all can be broken down into three major categories. What I shall outline is not intended to be an all-inclusive guide, but one establishing general principles that are flexible enough to fit particular situations.

One of the first questions to settle is the type of products (or product lines) that you are looking for in the ideal potential acquisition candidate.

Then ask yourself if these products are primarily in the growth areas that you have selected as being those in which you desire to participate. For example, there may be a very fine company available with an excellent sales reputation, but query as to whether you wish to buy such company if its present product line consists of buggy whips.

Next, are these products compatible with either your existing operations or the type of industry into which you desire to expand? Try to confine your search to companies that fit into your growth plan, rather than buying anything that comes along and finally ending up with products in 15 or 20 different fields without knowing how you got there in the first instance.

The second category to which I believe you should give serious consideration is the subject of sales. First, what should be the minimum annual sales volume of an ideal acquisition candidate? You may say, "I wish to confine my search to companies that have an annual sales volume in excess of so many dollars." Whether that minimum is $20,000,000 or $500,000 will depend on your company's particular circumstances, its capabilities, and also the industry in which the acquisition candidate is participating. Second, what has been the past sales growth record of the particular company and what do you anticipate will be its future sales growth? I think it is quite apparent that if the company has had no sales growth in the past, and it is in an industry that seems to be pretty stagnant, you probably would have no desire to acquire such company or to participate in that industry.

The third major category is the profitability of a company. You should establish minimums for your own particular program. In my opinion, three tests should be applied concerning profitability:

1. *The minimum profit return expressed as a percent of the particular company's net sales.*

This is something that will vary by industries. For example, in the food industry profit as a percent of net sales is low, but in certain other industries a 15% or 20% return on net sales might be considered mediocre.

2. *The minimum profit return on net worth or shareholders' equity in the particular company.*

A company may be in an industry where the percent return on net sales may be only 1.5% or 2%. Yet this company could be a very attractive acquisition candidate if its annual profit is, for example, 30% or more on the shareholders' investment. In this connection, there is the further question of whether you wish merely to look at return on book net worth (capital plus surplus) or at the profit return on invested capital (e.g., fixed assets, inventory, and working capital).

3. *The minimum profit return on the indicated purchase price (your initial investment) in that particular company.*

Let us say the particular company presently is returning a 30% profit on shareholders' equity, but that the purchase price is significantly in excess of its shareholders' equity. In such a case, will you be willing to live with a profit return that may be as low as 1% or 2% of what you must pay to acquire that company?

Other Considerations

The foregoing are the major items to be considered in your initial screening. However, there are certain other things that you should look into at the same time. One is whether the company is large enough and has been in business long enough to establish some kind of reputation. Ideally, the company should have a good reputation for its management ability; its marketing, engineering, and manufacturing skills; and the quality and acceptance of its products. Moreover, the company should already be an established factor in its own industry so that you will not be confronted with the problem of trying to grow up in, or of breaking into, a particular industry or market.

Another important item is whether the particular company you are screening as an acquisition candidate has many or just a few customers. In my opinion, a very dangerous situation exists if the company's business is dependent on a few customers.

Last, but not least, you should determine whether the acquisition price for a particular company would cause any dilution in your own company's earnings. Where shares of your company's common stock would be issued to acquire the company in question, you can use this rule of thumb: if the per-share purchase price represents a price/earnings ratio of more than what your own company's stock is selling for, such price will cause a dilution of your present shareholders' earnings.

The question of dilution of earnings arises even in cases where an outright cash payment is to be made for a company. Since such money could be used elsewhere, you should look on it as borrowed money and compute the annual net after-tax cost thereof at current interest rates. If the current annual net profits of the candidate you are screening do not exceed such costs, then, in

effect, there will be dilution of your company's earnings. Thus you have to determine what dilution of earnings, if any, you are willing to accept to acquire a particular company.

I think you can readily see that the answer depends on the company in question. If it has been in existence for a long period of time, certain standards will apply. On the other hand, if the company is comparatively young and shows an excellent growth record, then certain other standards will have to be used. Accordingly, are you going to be so concerned about immediate dilution of your company's earnings that you will look primarily at the candidate's past earnings? Or are you willing to accept a certain amount of present dilution with the expectation that in succeeding years the company to be acquired will grow and eventually make a contribution to, rather than dilution of, earnings?

Ideally, the company to be acquired, rather than causing a dilution, will contribute to your own earnings so that it will be a profitable acquisition from the very start.

FURTHER EVALUATION

After establishing your own standards, I suggest that you design a rating sheet (a) to evaluate further the qualifications and acceptability of your acquisition candidates (probably none of which will meet or exceed all of your ideal specifications), and (b) to assign priorities. What constitutes a certain grade and what weighted values should be assigned to particular categories will depend on what you feel is most important. Unless you use some sort of rating and assign priorities to those companies brought to your attention, considerable time and effort on your part may be wasted.

After you have screened out the less desirable opportunities and have assigned certain priorities to the remaining candidates, a more detailed investigation of them should then be conducted. This, again, is a two-step affair: the first involves additional investigation and screening both before and after you have discussed the matter with the management of the potential candidate; the second concerns what should be done after you have negotiated the transaction and entered into a definitive contract, but before the acquisition is formally consummated.

This detailed investigative process will depend on the particular circumstances, and I am sorry to say that you will find that each particular transaction is a unique case unto itself. Once again, however, you can establish certain guidelines and matters for further investigation. What you can do, in my opinion, depends on four things:

1. *The cooperation of the potential acquisition candidate.*

If the particular company is willing to give you as much information as you request, this makes your task much easier. In the majority of cases, you will find that you will be given answers to the questions you ask. But inasmuch as you do not know the company, unless the other side is willing to volunteer information, you still are not going to find out everything that you should actually know.

2. *Whether the warranties and representations in the acquisition agreement will survive the closing.*

Sometimes the seller is the type who says that there shall be no surviving warranties and representations. In other words, once the transaction is completed, he desires to walk away from it without any fear of recourse by the acquiring company because of information discovered subsequent to the closing. This point should have considerable bearing on how thorough your investigation will be.

3. *The time you are willing to allot to your pre-acquisition investigation.*

Are you willing to spend six months, or only two or three weeks? Ideally, the longer time you have the better off you are, except that this lends itself to procrastination. Unless somebody establishes a time limit for the investigation, people will tend to continue the investigation forever.

4. *The risks you are willing to assume.*

If you are only going to spend two or three weeks investigating a potential candidate before consummating its acquisition, you must be willing to assume certain risks. Some companies are willing to assume various risks in order to move quickly in acquiring another company which otherwise might be lost, recognizing that in doing so adverse matters about the acquired company may be discovered during a subsequent, detailed investigation.

What subject matter should be covered in your more detailed investigation of a particular acquisition candidate after its initial screening? I first wish to emphasize that in your initial screening of a company which is publicly held, much information concerning it can be obtained from financial services such as *Moody's Industrials* and from Form 10K reports filed with the SEC before even talking to any official of the company in question.

Financial Aspects

I shall discuss only briefly the principal subject matter that should be investigated, inasmuch as we could go on for hours on this particular area. Let us start with the financial aspects, since they cover most of a company's entire operation. Rather than attempt to discuss every conceivable aspect of this category, however, I believe that it would be better for our purposes

merely to point out what I consider to be some of the problems you may encounter and should look for. Of course, you will ferret out as much detailed information about them as you can from (a) the sources immediately available to you, (b) your subsequent discussions with officials of an acquisition candidate, and (c) your examination of the particular company's records after they are made available to you.

Inventory Matters. One of the financial problem areas—and these are not in any set order of priority—is inventory. Normally, this is where a substantial amount of the acquisition candidate's capital is invested. Accordingly, if the inventories are unusable and cannot be readily converted into cash, they will undoubtedly have a very adverse effect on the operation of the company after it is acquired.

I think it is particularly significant to look at the acquisition candidate's ratio between net sales and inventories, and to compare it with the industry's average. On the one hand, for example, a company manufacturing V belts should have a high turnover ratio of net sales to inventories. This is because V belts must be used within a certain period of time after they have been produced, or else they deteriorate in quality and become worthless. Thus if such a company's inventory turnover ratio is significantly less than the industry's average, you should be extremely cautious. Otherwise, you may find that you have acquired a company with an absolutely worthless inventory.

On the other hand, of course, if you are considering a company in the capital goods industry where, let us say, it takes 15 to 18 months to manufacture its type of products, there is generally not the same high turnover ratio that prevails for off-the-shelf products.

Although not applicable to every situation and industry, two questions generally may be asked: Are all inventories of the company in question less than one-year old? Can all inventories on hand reasonably be expected to be used, consumed, or sold within a period of one year as the business of the acquisition candidate is now conducted? Affirmative answers to such questions will give you fairly good protection against inventory obsolescence due to technological change.

Accounts Receivable. Does the company in question constantly age its receivables so that there is a good record of what receivables are current, what are past due, and what reserves have been established? What is customary in this company's industry? Do customers pay their invoices promptly, or are they extended long-term credit? What is the average percent of bad debts?

What is the average turnover ratio of net sales to receivables in the industry? Is the company in question better or poorer than the industry generally?

Keep in mind that in acquiring a company you are buying certain values. If the values are not as represented on the books, then the company's balance sheet and statement of income are overstated.

Accounting Practices. Without castigating anyone, I think that it is fair to say that there can be two companies in the same industry, producing exactly the same products and having the same general standard costs—but, if they apply differing accounting principles, their operating results will be different. And yet, the practices followed by each company will not only be generally accepted accounting principles, but they will be so certified by their respective auditing firms. Thus this is an area that can cause considerable difficulty.

What are some of the accounting practices that you should investigate? One is the depreciation policy followed by the particular company. Does the company charge the same depreciation for book and tax purposes? If it charges more depreciation for tax than for book purposes, this will in effect reduce the acquisition candidate's income tax and increase its reported book net income, as compared to that shown on its federal income tax return. How does the company report such differences in its published financial statements? Does the company follow straight-line depreciation, or some other—such as double declining balance or sum-of-the digits—method? Each of these accounting practices can cause substantial differences in the particular company's net income and depreciable assets' figures.

What accounting practice is followed with respect to costs of patents and trademarks? Does the company expense or capitalize them? If the company capitalizes all such expenses, in my opinion, its net income is overstated. If these expenses are written off as incurred, net income will be conservatively stated. Other companies follow the practice of capitalizing their expenses of patents and trademarks, and then amortizing them over various periods of time.

The foregoing discussion illustrates why it is important to ascertain how the acquisition candidate's net income has been calculated. By various standards is it overstated or understated? This same question applies to the cost of patterns, dies, and tooling. Is it expensed, or capitalized and depreciated over a period of time? In my opinion, companies are using sound accounting principles when everything possible is expensed rather than capitalized. Of course, such a conservative policy has an adverse effect on a company's net income, as compared with other companies which capitalize everything. This is par-

ticularly true for a company that does considerable defense work. For example, it may have a government order that runs, say, for a period of four years but requires extensive tooling in the first year. If the company expenses such tooling as incurred, this will have an adverse effect on the first year's profits.

What accounting practice is followed for investments in unconsolidated subsidiary operations? Many companies do not consolidate their foreign operations. Are these investments reflected in their balance sheets at cost or at equity? Are their unconsolidated subsidiaries operating at a profit or loss? What would the effect be on the income and balance sheet statements if those operations were consolidated?

Pension Programs. Assuming the acquisition candidate has a pension program, you must ascertain what the program entails, how long it has been in effect, what the benefits paid under it are, how the program is being funded, what the current cost of it is, and what the amount of the unfunded past service obligation is.

At the present time not many companies show—even in the footnotes to their financial statements—any indication to unfunded past service obligation. Pension programs are growing and the benefits are becoming larger as time goes on. Thus the unfunded obligation can become a significant hidden liability that may give you very serious concern. In this connection, I know of one company that has net sales of less than $300 million a year and yet its unfunded past service obligation is in excess of $130 million. The company has a book net worth of approximately $150 million. Just how attractive would this company be to you if it were for sale? Unfunded past service liability will vary all over the lot. With a young company, because employees have only, say, two or three years on the job, there is little past service to consider. But if the company has been in existence for, say, 15 years, the question does arise. If the acquisition candidate has no pension program, how long could you go along before it would become necessary to institute such a program, and what could you anticipate that it would pick up concerning past service?

Additional Financial Areas

Another, and a very vital, problem area concerns the status of the acquisition candidate's tax returns and the adequacy of its tax reserves. Unfortunately, there still are companies that have tax years open as far back as 1949. Have the tax returns filed by the acquisition candidate been prepared on a basis consistent with that with which it has settled prior tax returns so that the same issues will not give rise to additional assessments?

Still another consideration is whether the company to be acquired has any business that is subject to statutory renegotiation. And, as an ancillary matter, does the acquisition candidate have any business where its sales contracts are subject to price redetermination? What are the potential liabilities in each case?

What are the particular company's present unexpended capital commitments, and what are its capital requirements for the next several years? Even though the company may look very good on the basis of its financial statements, if it has unexpended capital commitments for significant amounts and if it must spend substantial sums during the next two or three years to keep itself competitive, a serious question may arise as to whether you will have the necessary capital with your combined operations to carry out that investment program.

How do you find out about contingent and undisclosed liabilities? This is not an easy task. Frankly, I know of little that you can do on this before talking to the company officials other than going through the footnotes of the company's audited financial statements.

What is the extent of the acquisition candidate's backlog of unfilled orders? Are you buying a company that has a good backlog, or does it have only enough customer commitments for a very short period? Again, I think that you should be flexible enough in your thinking to look at the particular industry and try to ascertain what is customary in that type of business. A very important second question is how profitable are these unfilled orders? There have been numerous instances where companies have acquired other companies with very significant backlogs only to discover later that the acquired companies had unprofitable unfilled orders. I know of one case where the losses on the unfilled orders exceeded the purchase price of the acquisition itself.

OTHER INVESTIGATIVE MATTERS

Because of space limitations I shall very briefly cover some of the other major categories that call for a detailed investigation.

Plant Operations

What is the condition of the acquisition candidate's physical facilities? Has good maintenance been regularly carried out, or are the property, plant, and equipment in a deteriorating state? Is this a case where the owner decided several years ago to sell his company, and during the interim deferred all possible maintenance so as to increase his profits?

Does the company have up-to-date equipment or is it obsolete, thereby necessitating considerable expenditure in the future in order to modernize the plant? Where is the plant located? Is it readily accessible to raw materials? Is it located near its markets? These are questions that are pertinent to any type of operation.

How efficient is the manufacturing layout? Are transportation, utilities, and raw materials readily available? Are supplies limited as far as the quantity is concerned? How many suppliers are available for the types of raw material purchased? Is the company dependent solely on one source or are there a number of suppliers? Is the plant operating at capacity or does it have any unused capacity? This latter point is very important if you hope to expand the business. What capital expenditures will be required in the future to expand the operation if the plant already is operating at capacity? What are the company's inventory and production controls? What percent of the work within the plant is subcontracted to outside concerns? Is this an assembly or a manufacturing operation? How much value is added to the product by work done within the company itself?

Patented Processes. Another major category for investigation is whether any of the processes employed by the company are patented. This is a two-edged sword. How important are patents to the operation of the particular company? Does the acquisition candidate itself have a patent on something it can license to others? Or is the company to be acquired dependent on a license from somebody else? If it is a licensee, what are the terms and conditions of that license? Is there any possibility that the sale of the particular company would give the licensor an option to cancel? How dependent is the business on the licensed operation?

Engineering and Research. What does the company do in this connection in relation to its own size and compared to other companies in its industry? Does it have capable individuals for engineering and research to keep up with technology and to remain competitive? If the company has a research program, is the money being expended wisely or do you consider it to be wasted? What are the backgrounds of the personnel in the engineering and research departments?

Marketing Orientation. I am using the term "marketing" as a catchall that includes selling, advertising, sales promotion, communications, public relations, and market analysis and surveys. What is the company's past history in this regard? How qualified are its individuals? How are the marketing

personnel organized and controlled? Who are the principal customers and how many of them are there? What are the company's markets and where are they located? If the company has overseas operations, how are its sales handled? Does the company consider the world as its principal market, or does it consider foreign countries merely as places to dump its products?

Industrial Relations. What has the company's personnel history been? Does it have a union shop? What are its relations with its employees? How do its wage scales compare with those of other companies? I believe you will often find that a nonunion shop tends to have higher employment costs than a union shop in order to keep its employees happy. What fringe benefits are there in the particular company? How do these compare with your own and with others in that particular industry? If the fringe benefits are substantially less than what you have in your own company, how long can you expect that situation to continue after you acquire the company, and what will be the added costs to give the new employees the same benefits as your present employees? What will be the effect of such added costs on the profitability of the acquired company? Of course, if employee benefits of the acquired company are greater than those for your present employees, how long will it be before you will have to increase their benefits, and what will be the added cost of such an increase?

Community Relations. What is the acquisition candidate's standing in its community? Does it have any environmental health problems? In this connection, is there a waste disposal problem? Does the company's manufacturing process pollute the air, water, or the ground? Does the company have suitable antipollutant devices? Is management cooperating closely with local government officials to eliminate such environmental health problems insofar as feasible?

REASONS FOR AVAILABILITY

Last, but not least, is the question of why a particular company is available for acquisition? There are a multitude of answers to this question and many legitimate reasons why a company can be acquired.

A very classic case, I believe, is a comparatively young company which has grown so rapidly that it has run out of working capital despite its excellent profits. The founders do not have the wherewithal to continue to finance and expand the business. Then, again, a successful, small young company may be available because the type of new programs that it desires to undertake, including research, can be financed only by a much larger company.

On the other hand, an old established company may be available because of the fact that the founder has reached an age where he must consider what will happen when he can no longer run the business. He may have a family that has no desire to remain in the business. If that is so, what will happen to the business? When he dies, how will the estate and inheritance taxes be paid if all of his assets are tied up in the business? In addition, how will the business be valued for such taxes?

Another valid reason why an owner may wish to sell his company may be that it is in a very limited field, and he may prefer to be part of a much more diversified company.

CONCLUSION

What are the two ultimate objectives of this screening process? The first is to make your acquisition program selective. The other is to make certain that the majority of your acquisitions are successful.

Let me add one final remark by saying that it is important to establish guidelines for your acquisition program but you must realize that probably none of the candidates will meet or exceed all of your ideal specifications. And finally you come to the point where a particular company becomes available which neither fits into any of your programs, nor complies with any of your corporate objectives, but it is so attractive that you just throw everything out of the window and buy it.

Floor Discussion

QUESTION: One particular problem that I was involved with for some time, and you made a reference to it, is the backlog of unfilled orders. Is there any way that you can guarantee a backlog's degree of profitability?

MORAN: It depends upon how capable you are in negotiating the terms and conditions of the acquisition agreement. How willing is the selling company or its stockholders to warrant that the backlog is profitable, or that at least you will not lose money on it based on present costs.

QUESTION: Do you think you can build that into the contract?

MORAN: Yes, sir. It has been done. It depends on how adamant the selling company is as to what will not be warranted, how eager you are to acquire that company, and what risks you are willing to assume.

QUESTION: At what juncture would you exchange letters of intent?

MORAN: I prefer just to have a definitive contract with no letter of intent, be-

cause a letter of intent is merely an agreement to agree. You can become bogged down in attempting to negotiate the terms and conditions of the definitive contract. To answer the question more directly, however, in cases involving large publicly-held companies—which are obligated to publish and issue information because of SEC and New York Stock Exchange rules and regulations—an appropriate time for a letter of intent is when agreement has been reached as to the major terms of the proposed transaction such as price and stock exchange ratios. Sometimes, the management of the company to be acquired will also wish to incorporate in the letter of intent a statement as to how its company will fit into the combined operations.

QUESTION: I'd like to go back to that backlog profitability again. How can that be done in the contract to guarantee that the buyer is getting the backlog that the seller says he is?

MORAN: Let us take a simple example. A company has only one stockholder, and you enter into the agreement to acquire his stock for cash. Ideally, the contract will contain a provision whereby the seller warrants that the company has a backlog of not less than so much and that the profit before tax on his backlog will be not less than a certain percent. Further, if the profit is less than that percent, the seller must reimburse you for the difference. It is a question of negotiation: What is the seller willing to warrant and represent, and what are the minimum warranties and representations that you are willing to accept?

QUESTION: Then does it become a situation where the buyer, after the acquisition is completed, puts on an entirely different set of overhead controls?

MORAN: Again, this comes back to the phraseology of the particular warranty and representation. Very often you will find that such warranty includes the phrase that the profit return will not be less than a certain percentage "as the business is now conducted." I defy anyone to spell out every possibility, and there will always be areas of discussion and dispute as to what changes have been made in the business. But if the seller is astute enough, he will recognize this particular problem and try to guard against it.

QUESTION: Would you please repeat what you said about the ultimate objective of the screening process being twofold?

MORAN: First, make your acquisition program selective, and second, end up with a successful acquisition. Unfortunately, I think the history in our country during the last ten years is that more than one third of these marriages have been unsuccessful.

QUESTION: What is a good return on investment rate for this kind of acquisition?

MORAN: I will go back to my early remarks and stress the point that it depends on the particular industry you are in. To answer it in a hypothetical way, a very good return would be to recover your purchase price in one year. In other words, if you paid $1,000 and the acquired company earned $1,000 the next year, that would be ideal. But you should relate it to the particular industry in question. However, if you are going to look at it from a personal standpoint, and you have a million dollars to invest, what rate of return would satisfy you—5%, 10%, or 2%? I think this comes back to your own preference.

QUESTION: What about making the announcement to the public? When does this take place? At what stage?

MORAN: This will vary according to the companies involved, and it will also depend somewhat on the desires of their respective managements.

QUESTION: What if both companies are listed?

MORAN: Then you must comply with the regulations and rules of the SEC and New York Stock Exchange. The very latest, I think, that you can defer it to is your letter of intent. To me, it is the point of time when you have agreed on the major questions such as price and the type of transaction involved—that is, a statutory merger or a B or C type reorganization, whether stock is to be used, or whether it is going to be strictly a purchase of assets for cash.

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Chapter 16

The Fine Art of Valuation

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Value, like beauty, is often in the eye of the beholder. Like beauty, it also can be ephemeral or it can be enduring. The process of determining, in a rational way, what a certain asset, group of assets, or company is worth is the foundation of the investment banker's role in any merger or acquisition assignment. Although most valuation work is done within the framework of a specific transaction and for a specific client, an investment banker also must be knowledgeable about how others will perceive the value of the property in question and how market forces or the business needs of others can affect the price at which an asset or company will clear the market.

A well-executed valuation of the company under study enables the investment banker to:

- Determine the appropriate range of acquisition values for the company, and advise the client as either a seller or a buyer
- Advise the client regarding the feasibility of a proposed transaction (either acquisition or divestiture) using the valuation as a frame of reference and the client's own views about value as guidelines

- Prepare for negotiation with the principal and the advisers on the other side of a transaction
- Opine on the fairness of the transaction to the shareholders of the client

The advice that stems from a thorough valuation, in short, is precisely the advice for which a client turns to his banker.

APPROACHES TO ACQUISITION ANALYSIS

Because valuation is the foundation for so many facets of advice, it is not surprising that "valuation" may encompass several distinct but closely interrelated concepts. None of these valuation tools is inherently better than the others, and each method is used in different circumstances. The two primary valuation concepts used by investment bankers are intrinsic financial value and acquisition value.

Intrinsic Value

Intrinsic financial value captures the discounted present value of the free cash flows generated by the assets of a business as a going concern plus a terminal value of the business, also discounted to the present at an appropriate discount rate. Thus, intrinsic valuation looks at a time series of financial flows over a certain period and attempts to estimate what a purchaser would pay for these cash flows from a purely financial point of view. The discounted cash flow (DCF) methodology used to arrive at this value is necessarily predicated on a series of assumptions about the nature of the cash flows and a judgment as to the appropriate rate at which to discount these flows. The intrinsic value of the company, therefore, *changes* as the assumptions from which the forecasts are generated or discounted are changed. As is true in most analyses, a DCF valuation is only as good as the assumptions or projections on which it is based.

The investment banker will assume a leading role in testing the credibility of any forecasts used for the DCF analysis and even may be called upon to develop a forecast in consultation with the client. Whether supplied by the seller or the buyer, or developed by the banker, the projections always must be subjected to a test of reasonableness. One of the most exacting tests of reasonableness is to compare the historical performance of the company on certain key financial measures (e.g., rate of sales growth, profit margins, capital intensity) to the forecasted performance. A forecast that, for example, projects dramatic improvements in margins (as is often the case in sellers' projections) must be investigated further before it is accepted at face value. As a cross-check, the investment banker often will prepare an analysis that compares the historical and projected financial performance of the specific company being valued to the performance of comparable companies. Moreover, by analyzing the forecast and using his or her knowledge of industry economics, the banker can give closer scrutiny to the line items that are most crucial to the free cash flow generation of the target.

Acquisition Value

The acquisition value of a company, which may differ significantly from its intrinsic financial value, seeks to estimate the price at which the company would "trade in the market for corporate control." Acquisition value thus is the price an acquirer would pay to control the target's assets and the free cash flows (FCFs) they generate. Two other observations about acquisition value are appropriate. First, a market for corporate control undoubtedly exists. Transactions occur almost daily at prices significantly above current secondary trading levels. Investment bankers continually are conducting public and private auctions which attract a number of bidders. Experience shows that these contests in the market for corporate control can be very competitive and therefore should accurately reflect value.

The second observation about acquisition value is that the value of a company as an independent entity often will be different than the value of the company when it is combined with another firm. The acquisition value will reflect the incremental cash flows generated by consolidated tax savings, cost savings due to the elimination of redundant operations, distribution economies, or other such synergies. Synergy is a controversial topic, and the actual realization of synergies is infinitely more difficult to achieve than the recognition that they should exist in certain situations. But if synergy is reduced to this limited definition—incremental increases in free cash flow that come about *because* of the combination—it is clear that valuation should take into account the synergistic elements of any proposed business combination.

Liquidation and Replacement Value

There are other valuation concepts that an investment banker may consider. In transactions in which assets are important factors, both liquidation value and replacement value can be quite useful. Liquidation value is an estimate of the net proceeds (after expenses) of selling the assets of the company at their fair market values and satisfying all liabilities and paying taxes. Some estimate of the time horizon over which the liquidation will take place must be developed also, so that the present value of the liquidation can be estimated. Liquidation value will often represent a floor or minimum value for a transaction. An estimate of the replacement value of the company—duplicating at current costs all of a company's assets—also may be a relevant measure, especially if a potential buyer is viewing an acquisition as an alternative to entering the business *de novo* or completely by internal expansion.

In addition to intrinsic and acquisition value, investment bankers typically attempt to estimate, on a pro forma basis, the market valuation of a publicly traded acquirer after a contemplated acquisition transaction is completed. To perform this task, the pro forma financial and business effects of the merger on the acquirer are calculated (especially the pro forma earnings pickup or dilution and key credit statistics), and a judgment is made as to how the combined entity will trade in the marketplace, both in the near term and over time. Pro forma financial analysis can be especially critical when the contemplated transaction

is large in relation to the size of the acquirer. It is usually desirable to evaluate the pro forma impact *prior* to initiating a transaction, because it helps to clarify the relative attractiveness of the transaction over a range of values and because it may help to set limits on the value the buyer will (or should) pay.

PRACTICAL VALUATION CONCEPTS

Having laid out various types of valuation analyses that investment bankers perform and some of the rationale for their use, we can present a more detailed discussion of these concepts and the attendent methodologies. One should realize that in many real-world situations all of these valuation processes will proceed simultaneously, waxing and waning in importance according to the client's state of mind and the competitive dynamics of the transaction. Most important, valuation analysis often must be performed in a compressed time period and based on remarkably incomplete information.

Intrinsic Financial or DCF Valuation

To state the premise again, DCF valuation posits that the buyer purchases a time series (into infinity) of free cash flows that are generated by the assets he or she is buying. DCF does not value the *total* cash flow of the business. Rather, it values only the *free* cash flow. In so doing, this analysis separates and ascribes value only to the cash flows that can be taken out of the business. Cash that is generated but used to sustain the business (such as increases in working capital and capital expenditures) does not count in the DCF value. Cash flow that must be retained in the business creates no incremental value for the buyer.

Another methodological nuance should be noted before free cash flow can be fully defined. As explained in detail below, DCF valuation uses a discount rate that reflects the firm's weighted-average cost of capital or the price it must pay to suppliers of both debt and equity. Accordingly, the free cash flows to be discounted should be developed independent of financing costs. In valuing a going concern with existing liabilities, therefore, the aftertax cost of interest is added back to the cash flow to create an unlevered free cash flow. It is this series of free cash flows that, when discounted to the present and combined with a terminal value (also discounted to the present), represents the economic value of the firm on a stand-alone basis. Thus, free cash flow in any given year of operation is defined as:

	Net income (after taxes)
plus:	noncash charges
plus:	aftertax interest cost (interest expense)(1 − tax rate)
less:	capital expenditures
less:	net investment in working capital
equals:	free cash flow (unlevered)

Terminal Value

As noted earlier, DCF valuation seeks to value the company as a going concern into infinity. As a practical matter, however, no banker or businessperson is comfortable with projections going out 20 years, let alone 100 years or infinity. So DCF valuation is separated into two components: a forecast of FCFs for some term of years, and a terminal value that is a surrogate for the present value of the FCFs that occur in the years after the end of the forecast period. Typically, we construct five to 10 years of pro forma financial statements, derive the FCFs for the forecasted years, and then estimate a terminal value for the company.

Terminal value at the end of the period of cash flow forecasts may be arrived at in different ways, such as estimating book value, applying a price/earnings multiple to forecasted earnings, or employing a cash flow multiple. Terminal book value is estimated by projecting the balance sheet forward to the last year of the forecast horizon and arriving at the book value of the common equity account at that time. It is assumed, under this scenario, that the interim free cash flow has been paid out. A terminal price/earnings multiple essentially values the firm at the end of the horizon in the same way that the stock market would value it—by capitalizing the then current earnings. The choice of the proper price/earnings (P/E) multiple will, obviously, have a large effect on the terminal value, and care therefore should be taken to choose a multiple consistent with the characteristics of both the industry and company at that time. It would be nonsensical, for example, to use a very high P/E at the end of the horizon for a company that was forecasted to have stable margins and relatively low growth rates.

The third means to estimate a terminal value, using a multiple of FCF, is slightly more complicated but methodologically more consistent with the premises of DCF valuation. In essence, this technique multiplies the FCF in the last forecast year by a multiplier that attempts to estimate the value of the cash flows in perpetuity. The multiplier is derived by the formula

$$\frac{(1 + g)}{(k - g)}$$

where g is the assumed rate of growth of the cash flow stream into the future and k is the weighted-average cost of capital. This formula capitalizes a stream that is growing at g percent into the future but being discounted to the present at k percent. In practice, the banker may use all three of these terminal value estimation techniques in an attempt to cross-check each method and instill greater confidence in the terminal value estimate.

Present Value Calculations

Once the series of free cash flows and terminal value are estimated, the present value of these two components must be calculated. An acquirer is paying *today* for access to the cash flows generated by the assets in the future; therefore, these

flows must be discounted to the present. The proper discount rate can be estimated by calculating the marginal weighted-average cost of capital ($\bar{k}$):

$$\bar{k} = k_e\,(\%\ equity) + k_d(1 - t)(\%\ \text{debt})$$

where k_e = cost of equity
k_d = pretax cost of debt
t = marginal tax rate
% debt = percentage of debt/total capitalization
% equity = percentage of equity/total capitalization

The cost of debt can be calculated fairly easily by looking at new-issue, medium-term debt rates for similar credits. The cost of equity, however, is calculated using the capital asset pricing model; that is,

$$k_e = r_f + B(r_m - r_f)$$

This equation shows that the return to equity holders, and so its cost to the issuer, depends on the level of return of a riskless investment (r_f) plus an additional return determined by taking on the level of risk associated with this company (B) and the long-term market return in excess of the risk-free rate ($r_m - r_f$). Investment bankers hew pretty closely to modern financial theory here, going so far as to unlever the beta (a measure of the risk of shares of publicly held companies) and releveraging it to the targeted or optimum balance of debt and equity. Bankers also will construct "surrogate" betas for calculating the cost of equity for nontraded subsidiaries or private companies. As a practical matter, however, the weighted-average cost of capital never is used as a point estimate of the "right" discount rate. Instead, this calculation defines the center of a range of discount rates (usually one to two percentage points on either side of the estimate) that will be used to discount the cash flows.

Cost of Capital

Another DCF methodological point needs to be made. The proper weighted-average cost of capital to be estimated is that of the *acquiree*, not that of the acquirer. This strikes some clients as counterintuitive: Why not use the buyer's weighted-average cost of capital? The acquiree's cost of capital, to give the shortest answer, captures the inherent risk associated with its assets and, thus, the uncertainty regarding the timing and the magnitude of the cash flows generated by those assets. (Stated another way: The target's cost of capital is the price it must pay to the suppliers of capital to motivate them to invest in that company.) When this approach is utilized, it becomes clear that use of the acquirer's cost of capital focuses on the wrong bundle of risks in constructing a discount rate.

Investment bankers spend a goodly portion of their time performing sensitivity analysis on a DCF valuation. A DCF is only as accurate as the assumptions underlying it, and the most direct way to delineate the margin of error is by varying the assumptions—in effect, designing different operating or financial scenarios for the company—and noting the results. Sensitivity analysis always focuses on the key line items that most affect the valuation. Throughout these financial gymnastics, the range of discount rates is held constant. (Remember

that the discount rate captures the risk associated with these assets: that is, it accounts for the variability in the timing and magnitude of the cash flows.) The result of the sensitivity phase of analysis is a range of values for the company or assets in question at a given discount rate.

Acquisition Valuation Methods

Acquisition valuation is perhaps less theoretical and more concerned with the real world than DCF valuation. It is an attempt to estimate where a company will "trade" in the market for corporate control. An obvious starting point in determining acquisition value is current stock market trading levels, or for a private company, an estimate of where it would trade in the public market if it were publicly traded. Such estimates usually can be made easily, and within reasonably tight parameters, by comparison with similar public companies and by analyzing the financial and business characteristics of the property in question. The value of a company in the market for corporate control usually is higher (and often very much higher) than its value in the secondary trading market. This result is news to some financial reporters and baffles some academics, but in the end redounds to the benefit of the shareholders.

Why is this? Part of the answer is found in the word "control." If nothing else, control of assets and the ability to direct all of the free cash flow generated by assets are worth more to a business manager than participation in a small percentage of a business, without control, is worth to the individual stockholder.

Although in some instances acquisition values will be very similar to DCF values, in other instances they may be quite different. In arriving at acquisition values, an investment banker must go beyond DCF analyses and use accumulated knowledge and judgment. A thorough knowledge of comparable precedent transactions, and an up-to-date and accurate assessment of the wishes, corporate strategies, business economics, peculiarities, and points of view of the known and potential participants in any given merger or acquisition transaction, are all essential to this valuation.

Multiples in Acquisition Prices

Analysis of acquisition precedent—or the record of comparable transactions—is a fairly straightforward means to begin to establish acquisition value. The investment banker is looking at price as a multiple of ______, and the "blank" can be filled in with any number of financial measures. The most commonly used measures are earnings, book value, and cash flow.

These multiples will vary in the acquisition market for the same reason they will vary in the secondary trading markets made on the floor of the New York Stock Exchange. Companies with characteristics such as superior sales and earnings growth records, better financial returns and prospects, sustained consistent performance, and strong brand franchises will be *acquired* for higher multiples—just as companies with these characteristics will *trade* at higher multiples on the Exchange. A fundamental assumption of this analysis is that companies in the same industry share common characteristics that should be reflected in their acquisition valuation. In fact, the evidence shows that multi-

ples paid in acquisitions in a given industry will cluster around a certain norm. The variations around these benchmarks can be significant, however, and it is the investment banker's job to understand thoroughly the reasons for the variability.

The investment banker also must be wary of any distortion in the financial statistics used in such calculations. These figures always should be calculated on a consistent basis—free from distortion because of accounting conventions, for example. Two very common sources of distortion are cyclicality and leverage. For a company whose margins and earnings fluctuate markedly throughout the business cycle, the point in the cycle at which the business was sold will affect the P/E paid. Cyclicality can be corrected for quickly, however, by using an average operating margin over a full business cycle and restating the target's income statement in the period prior to acquisition, thus using a "normalized" margin rather than the actual or reported margin. Normalization—and this point should not be lost in the elegance of the solution—necessarily assumes that the margin pressure is cyclical and not due to some long-term, secular alteration in the margin structure of the industry. Additionally, an investment banker may find that normalization is not an adequate solution because a buyer always will ascribe less value to the company when the target is on the downward leg of the cycle (where the cash flow picture is weakening and improvement is well in the future) than on the upward leg (where cash flows are improving over the near term). A second major area for scrutiny is the effect of interest expense on earnings. The solution to this problem is to restate the P/E paid on a gross unlevered basis, that is, total price paid (the purchase price of equity and the market value of the debt on the acquiree's books) divided by earnings before interest and taxes. This adjustment may be particularly important when dealing with a subsidiary of a company that carries debt only at the parent level.

The multiple of book value paid is, for certain types of companies, also a useful pricing mechanism in the market for corporate control. Again, one must ensure that different accounting conventions are adequately taken into account. A book value multiple is a better predictor in industries that employ stable technology and are relatively capital-intensive. Book value multiples also are used widely in the financial services industry, where they function partially as surrogates for net liquidation value because the assets and liabilities are carried at values (theoretically at least) close to market. The multiple of cash flow, intuitively attractive because of the potential relationship to DCF valuation, also can be very useful.

Many other specialized multiples are employed in the valuation process in situations where the denominator of the fraction bears particular business significance for the industry. Oil companies, for example, can be valued on the basis of dollars paid per net equivalent barrel of reserves to recognize the underlying asset value of the hydrocarbon assets. Cable TV operations, to cite another example, often are valued by looking at multiples associated with their subscriber base. Examination of comparable transactions, using either traditional or industry-specific multiples, is not a mechanical process but an exercise of judgment. As with DCF valuation, the process does not produce one "correct" value but a range of defensible values. In examining this range of values, assum-

ing they are based on comparable statistics, an investment banker also must be aware of environmental factors such as the level of interest rates, or the general expectation of the direction of certain commodity prices, such as the price of oil, at the time specific transactions were negotiated.

The Art and the Judgment

In the end, even when armed with the results of various analyses such as DCF values, secondary market trading levels, a history of comparable transactions, and estimates of liquidation or replacement values, the evaluator moves from the arena of seeming precision and science to the realm of judgment and art. What seems dear to one professional may be cheap to another. Factors such as market knowledge, negotiating ability, and even good luck all can cause changes in the perception of value. A company with tax loss carryforwards, excess distribution capacity, a strong business imperative to round out or add a specific product line, and an unhappy history of building new businesses from scratch can look at exactly the same analyses as a similar company without these characteristics and find much more value in a specific acquisition candidate. Likewise, a company with a certain culture or way of doing business may find more value in a company whose culture is similar than will another would-be acquirer whose approach to managing its business is very different. The knowledge of these intangible factors, the ability to use this knowledge, imagination, and creativity enable a good investment banker to elevate valuation from a science to an art. Ultimately, the ability either to affect "the eyes of the beholder" and what these eyes perceive as value, or to find the right "eyes," is a skill that is based on the results of analysis but goes beyond the pure mechanics of analysis.

One final word on "market premium," a concept that commands much attention in the press and in certain scholarly journals. It has been our experience in practically all major control transactions that the premium paid over the market trading level of the stock of the company is a derived figure rather than an analytical tool or concept in its own right. When the various types of analysis outlined in this chapter justify values over current secondary market trading levels, an acquirer may enter into a transaction at a premium over these market levels. But the decision to pay a premium to current market value rests on the *conclusion* of the analysis and is not a valuation exercise in its own right. DCF values and comparable transaction multiples, adjusted for specific transaction or environmental factors, offer a much more consistent explanation of the values paid in control transactions than a history of premiums paid over market trading levels. However, market premium is a useful concept in assessing how a seller or its shareholders may react to a specific proposal. There are examples of control transactions being completed at very low or negative premiums (discounts) to market. But as a practical matter, if no premium is offered, many transactions will have small likelihood of success, regardless of the validity of the valuation analysis supporting the buyer's position. The major exception to this observation is the relatively rare "merger of equals" transaction, where little or no premium is offered or received by either party to the transaction.

Fairness Opinions

Performing the analysis and arriving at a value view puts the investment banker in a position to play many roles for the client. Bankers often are engaged primarily to form objective, third-party views on the value of the business to be bought or sold. The valuation exercise also can be a part of a more comprehensive involvement, in which the banker comes to a value judgment and articulates and defends that position in a negotiating context.

If negotiations lead to a transaction, the banker also may be asked to render a "fairness opinion" on the deal. A fairness opinion, which is addressed to a board of directors, expresses the investment banker's opinion that the price paid in the transaction is "fair from a financial point of view" to the shareholders of the company. The import of the opinion varies depending on the context in which it is rendered. When the banker represents the seller, the opinion gives comfort to the seller's board that the target's shareholders are receiving a fair price for their shares. When the banker represents the buyer, on the other hand, the opinion gives the board comfort that the price to be paid for the target is not so unreasonable that it is unfair to the shareholders of the acquiring company.

Pricing

The Art of Structuring A Private Company Deal

Jay Middleton Tannon

While prices are slipping and financing is harder to get, most of the fundamental elements of acquiring privately owned companies have endured. Prices and terms still are most often cued by the personal requirements and perspectives of buyers and sellers.

ESTABLISHING PRICES and payment arrangements for private company acquisitions never has been an exact science. Indeed, given the vast opportunities for creativity, structuring purchase prices far more resembles an art than a science. Yet basic concepts and guidelines have evolved. With the m&a market now experiencing a period of adjustment on pricing, and with commercial banks and other traditional financing sources refusing to extend credit as liberally as in the decade just past, this is an appropriate time to revisit fundamental issues in structuring purchase prices for private company acquisitions.

The purchase price can be as simple and straightforward as a fixed dollar amount established prior to execution of the acquisition agreement and set forth in that contract. The fixed acquisition price may be determined in various ways. Often, the parties negotiate the price after having independently arrived at a valuation based on one or more of the following: comparable companies, comparable transactions, discounted cash flow analysis, leveraged buyout or cash flow-for-debt-service analysis, a multiple of earnings, book value, an analysis of asset values, and largely subjective and emotional value.

Another means of determining the purchase price involves establishing a fixed price in the contract subject to adjustment. For example, if valuation of assets determines the purchase price, the parties may conduct a special post-signing or post-closing audit of inventory or receivables. In some instances, third-party appraisals will establish a price for fixed assets. A "fixed price" also may be adjusted pursuant to a "closing financial statement" prepared after the parties execute the acquisition agreement.

A formula price also contemplates the payment of a fixed sum at closing. However, instead of stating a fixed dollar amount in the acquisition agreement, the purchase price provision in the agreement establishes a formula upon which the purchase price will be determined and paid at closing.

For example, the acquisition agreement might

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state that the price will be five times the pretax earnings for the target company's last fiscal year and that such earnings will be determined prior to closing through a certified financial statement prepared by an independent accounting firm. Delivery of the certified financial statement to the purchaser constitutes a condition of the closing.

As yet another alternative, the acquisition purchase price may be made wholly or partially contingent on the post-closing earnings of the target company. Parties typically negotiate contingent purchase prices when a seller believes that past earnings do not reflect the earnings potential of the target company and when the purchaser must be convinced of the future earnings potential before paying the requested price. The seller gains some assurance that the purchase price will fairly reflect the target company's future earnings, while the purchaser guards against "overpaying" for the company based on its historical performance.

When negotiating a contingent price or "earn-out," the seller must resist the potentially hypnotic effects of a large earn-out figure. The seller who becomes entranced could receive very little at closing, and even less after closing. If the price must be contingent, the seller should secure a payment at closing with which the seller would be reasonably content, even if that payment were the only consideration the seller ever received in the transaction.

If the purchaser is assuming contingent liabilities, the acquisition agreement should address this matter explicitly. The purchaser should insist on full disclosure of any such liabilities.

Parties have many choices when determining the seller's precise participation in the target company's post-closing earnings. For example, if the parties negotiate a purchase price based on a multiple of the target company's earnings, the purchaser initially could apply the chosen multiple to past earnings and pay that sum at closing. The agreement also would call for the purchaser to make an additional payment when the stated earn-out period expired. The additional payment would equal a negotiated percentage of the difference between the average annual earnings during the earn-out period and those of a historical period multiplied by the chosen multiple of earnings.

Another option is for the purchaser to pay a fixed percentage of the target company's "profits" during the earn-out period. Common earn-out periods run from one to five years.

Firm agreement on a benchmark

Parties proposing an earn-out should resolve in the acquisition agreement the definition of "earnings," "profits," or "net income" used to calculate the contingent payment. To determine earnings equitably, the purchaser should agree to operate, or at least account for, the acquired business as a separate entity. The purchaser's accounting firm usually will determine the target company's earnings in accordance with generally accepted accounting principles consistently applied. Exceptions to such a standard may be appropriate and important, particularly to the seller. For example, if the contingent price is intended to reflect long-term earnings potential, the calculation probably should exclude extraordinary or nonrecurring gains and losses.

Among other issues, the parties also should consider establishing operating guidelines for the acquired company from the closing date until the end of the earn-out period. In these negotiations, the seller typically will seek assurances that the purchaser will operate the company in ways that the seller believes will maximize earnings during the contingent period. Such assurances often translate into proposals by the seller to retain dominion over some post-closing operations of the acquired company. For example, the seller may propose that, during the earn-out period, the purchaser obtain the seller's consent before developing new products or otherwise expanding the scope of the business in ways that could become profitable only after the earn-out period. The purchaser, conversely, wants maximum control over business operations during the earn-out period and often will strenuously resist the seller's officiousness.

The control a seller exerts during the earn-out period primarily depends upon the parties' relative bargaining positions. In some cases, the purchaser secures unfettered dominion over post-closing operations. In others, the seller may secure representation on the target's board of directors and retain a right to veto any board action. A frequent compromise position permits the purchaser to expand the acquired business in any commercially reasonable manner, if the earn-out formula excludes the results of any such expansion.

If parties are seriously considering a contingent

price, they should consult tax and accounting specialists. Numerous traps exist for the unwary. For example, if a deal with contingent price arrangements is to fall within the Internal Revenue Service guidelines for a tax-free reorganization, it must contain these features:

☐ Contingent shares of stock have to be issued within five years from the closing;

☐ A valid business reason must exist for the contingent payout;

☐ There must be a stated maximum number of shares issuable;

☐ At least 50 percent of that maximum must be issued at the closing;

☐ The right to receive the stock in the future cannot be negotiable or assignable;

☐ All stock received must be stock of the same issuer;

☐ The recipient must not control the events triggering payment of additional shares;

☐ The prospect of tax liability must not trigger the issuance of additional shares; and

☐ The mechanism for determining the number and value of additional shares must be objective and readily ascertainable.

The principal forms of purchase price consideration are cash, promissory notes, stock, and assumption of debt. In most instances, the seller will steadfastly pursue an all-cash transaction, especially when the seller's counsel succeeds in eliminating any escrow arrangements, representations and warranties, and indemnification. In an all-cash transaction, the payment provision in the acquisition agreement typically requires the purchaser to deliver the price at closing in cash, by certified check, by bank cashier's check, or by wire transfer.

A cash transaction constitutes the most desirable means of payment for the seller. Although deferred purchase prices often proffer greater face amounts, they rarely offer greater value to the seller.

When the parties' principal offices are not in the same city, the seller may find it advisable to require payment in local clearinghouse funds. That procedure will avoid the time required to clear a check drawn on an out-of-town financial institution. Sellers also should understand that a certified check is not the same as cash or federal funds. The certified check merely assures the recipient that the payer's account has sufficient funds to honor the amount of the check. Federal funds are checks drawn on a Federal Reserve bank and entitle the payee to immediate credit for such funds in any bank or financial institution. Consequently, if the amount is sufficiently large and even overnight interest would be significant, the seller should try to persuade the purchaser to pay in federal funds. In such arrangements, the acquisition agreement should not permit payment of the purchase price by any other means.

Bias toward Friday closings

Purchasers paying cash tend to favor late Friday afternoon closings in order to keep the funds working in their accounts for as long as possible. Sellers often counter by making special arrangements to facilitate the deposit of sale proceeds in their respective bank accounts.

Except for the fact that the seller almost invariably will recognize gain currently for income tax purposes, a cash transaction constitutes the most desirable means of payment for the seller. Although deferred purchase prices often proffer greater face amounts than cash prices, deferred prices rarely offer greater value to the seller. Before accepting a deferred purchase price, the seller should consider carefully the discounted time value of that deferred price, paired with the risks of interest rate fluctuations, subordination, setoff, and purchaser default. Of course, some sellers simply cannot tolerate the prospect of an immediate capital gain on the entire purchase price.

Even when a private company seller has an opportunity to defer tax consequences and take stock in a seemingly attractive public company acquirer, the seller should consider selling the company for cash and using a portion of the proceeds to buy shares of the purchaser's stock in the open market. Unless the seller becomes an affiliate under the Securities and Exchange Commission's Rule 144, the seller will not be locked into the investment in the same way it would if the shares were received as acquisition currency.

From the purchaser's perspective, an all-cash transaction constitutes the least desirable approach. A cash purchaser will have paid in full for the seller's business and precluded easy recourse, if the acquired business turns out to be other than as represented and anticipated. Without escrows, promissory notes, or contingent arrangements, the purchaser has no automatic offset and

faces the unenviable task of attempting to retrieve a portion of the purchase price from the seller. Moreover, without deferred payment, the seller may be less diligent in its disclosures, less helpful in the transition of ownership (i.e., dealing with suppliers, customers, and employees), and less interested in the post-closing success of the business.

If the purchaser cannot or will not pay the full acquisition purchase price at closing, the purchaser often presents the seller with some cash at closing and a promise to pay the balance at a future time. Although the promise to pay embodied in the acquisition agreement presumably will avoid statute of fraud problems for the seller, most sellers insist that promissory notes be executed and delivered to memorialize the indebtedness and the terms of the payment.

In negotiations on promissory notes, the interest rate and payment schedule are key issues. Interest rates often will track market rates of commercial lenders but may vary from "zero" to the highest rates permitted under usury laws.

The note itself can range from a straightforward promise to pay a specific sum to a multi-volume treatise. The requisite level of complexity will depend both on the substance of the given transaction and the characteristics of the parties and their advisers. Parties should resolve the form of the promissory note when they sign the acquisition agreement.

In any negotiations concerning a promissory note, the interest rate and payment schedule are key issues. Interest rates often will track market rates of commercial lenders but may vary from "zero" to the highest rates permitted under applicable usury laws. However, if the parties have determined that the note will bear "no interest," interest will nonetheless be imputed at the applicable federal rate under the Internal Revenue Code. Parties also should evaluate various amortization options, including "interest only" periods and "balloon payments" as alternatives to equal installments of principal and interest over a given term.

Another important issue is that of negotiability. The prudent seller will prefer a negotiable note, since that instrument offers greater liquidity than its non-negotiable counterpart. If the seller conveys a negotiable note to a third party, the purchaser no longer can assert claims against the note that arise from the seller's breach of the acquisition agreement. Ordinarily, banks and other sophisticated third parties only will buy negotiable notes, because they are free of purchasers' defenses against ultimate payment.

If the buyer cannot get a non-negotiable note, it thereafter harbors no illusions that it has a right of offset for the balance of the note term.

To achieve non-negotiable status, the note must state that it is non-negotiable or it must be drafted in the form of "pay to seller," rather than "payable to the order of seller or to bearer." Providing for a variable interest rate also can render a note non-negotiable, since the Uniform Commercial Code requires a negotiable note to contain an unconditional promise to pay a specific sum. Finally, failure to establish a definite repayment schedule or to make the note payable on demand can preclude negotiable status.

From the seller's perspective, the paramount issue in negotiating a promissory note is security for the deferred payment. When a seller accepts deferred payment, it should seek more extensive representations from the purchaser in the acquisition agreement. Although the seller is not receiving stock in the purchasing company, the seller is nonetheless becoming an "investor" in the post-closing enterprise. Since a note is a security, the seller does gain protection under the anti-fraud provisions of various federal and state securities laws. However, there is no substitute for pre-closing due diligence.

In addition, the seller should insist on receiving the full obligation of the principal economic entity or entities in the purchasing group. For example, if the purchaser utilizes an acquisition subsidiary, the parent company should guarantee the promissory note.

Peace of mind for the seller

The seller also should consider asking the purchaser to secure the deferred payment with a letter of credit issued by a substantial financial institution, the guaranty of a wealthy affiliate, or a pledge of assets. These can be all or part of the assets the seller has just transferred to the purchaser, or other assets of the purchasing group.

In a stock transaction, the seller often will ask the purchaser to pledge the shares the seller has just conveyed in the acquisition. This arrangement enables the seller to regain ownership of the company, should the purchaser fail to make the

required payments under the note. Alternatively, if the seller has transferred assets, it could seek a pledge of the purchasing company's stock. Given that the purchaser may default and the seller might regain ownership of the target company, the seller should seek contractual provisions that prohibit a purchaser from diverting the target company's assets and profits through affiliate transactions.

Hard-nosed positions

To preserve the company's assets, viability, and value, the seller typically will seek operating restrictions similar to those that a conventional lender would impose. For example, the seller might request minimum working capital commitments, minimum debt-to-equity ratios, minimum current ratios, or prohibition of business combinations and asset spin-offs without consent, compensation restrictions, or dividend restrictions.

Of these proactive provisions, the restriction on dividends generally produces the greatest discussion. The seller wants no dividends paid until the purchaser repays the note in full. The purchaser resists any restriction, because it usually has plans to fully utilize the target's cash flow. The parties often compromise by permitting a specified level of dividends after the purchaser has achieved certain note repayment thresholds.

If, as in most transactions, a third party, such as a commercial bank, provides a substantial portion of the acquisition financing, the parties also must resolve collateral division, subordination, and other intercreditor issues.

Naturally, the purchaser will resist all attempts to provide security for the note and will be particularly reluctant to agree to operating restrictions. Even when the bargaining power and equities of the situation cause the purchaser to make concessions, the purchaser should insist, absent a default, that it retain all voting rights. The purchaser also should seek to have all operating restrictions, or at least the bulk of them, terminated when the note has been substantially repaid. Essentially, the purchaser should agree to no more collateral than absolutely necessary to provide commercially reasonable security for the outstanding obligation.

Finally, when notes are received, the seller typically will seek to qualify the transaction for installment sales treatment under the Internal Revenue Code. That represents a difference between realizing gain on the entire price in the year of sale vs. booking gains as funds are received.

When equity securities of the purchaser constitute all or a portion of the purchase price, a host of issues arises, including the nature of the securities.

Will they consist of preferred stock or common stock? And what are the preferences, limitations, and relative rights of the securities? Liquidation preferences, pre-emptive rights, dilution, voting privileges, and put provisions are among the issues that should be thoroughly analyzed and vigorously negotiated. The parties also must consider the impact of issuing stock upon indemnification, with particular emphasis on whether and just how the seller can use shares to satisfy any liability.

Other issues, such as valuation, future registration rights, rights of first refusal, and securities law compliance, weigh heavily in transactions in which equity securities are utilized.

All the terms and conditions of equity securities used as acquisition currency should be fully negotiated in the acquisition agreement, rather than left for the period between signing and closing. The purchaser should know exactly what it is giving and the seller should know exactly what it is receiving, before their obligations become fixed. After all, the parties are now investing in each other. Although the use of equity securities can forestall recognition of gain and the attendant tax payments, a seller's agreement to take stock in an acquisition never should be undertaken unless the parties truly wish to become business partners.

Federal and state exemptions

When the consideration partially or entirely involves securities of the acquiring company, federal and state securities laws, particularly the Securities Act of 1933, could have a significant impact on the transaction. Even if either party or both parties are closely held companies, the 1933 Act applies to the transaction, unless all persons receiving stock are residents of the state in which the acquirer is located and conducts the substantial majority of its operations. The law requires the registration of all securities offered for sale, unless a specific exemption exists for the securities to be sold or for the transaction in which the securities are to be sold. Since an exemption for the securities rarely exists, the parties almost invariably focus on a possible exemption for the proposed transaction.

The two exemptions most widely used by issuers of stock in a merger or share exchange are the intrastate exemption and the limited offering exemption of the SEC's Regulation D. Other notable

exemptions include the exemption for transactions "not involving a public offering" and the limited public offering, or mini-registration, exemption of Regulation A. If a federal exemption is available, exemption from state "blue sky" registration usually will be available as well.

Properly perfected, the exemptions from federal and state securities law registration requirements eliminate the need for the issuer to wade through the cumbersome registration process and avoid creating guarantor status for the issuer and its controlling persons. While some exemptions are self-executing, others may require the filing of claims for exemption. Almost invariably, pursuing and perfecting an available exemption for the issuance of stock in an acquisition is faster and less expensive than proceeding through the registration process.

When the parties' principal offices are not in the same city, the seller may find it advisable to require payment in local clearinghouse funds. That will avoid the time required to clear a check drawn on an out-of-town institution.

Target company shareholders that receive stock of the acquiring company in a merger may be subject to restrictions on the resale of the stock because of the utilization of an exemption rather than registration. For example, under Rule 147, the SEC's safe harbor intrastate offering exemption, recipients of stock must agree not to transfer it to an out-of-state person for nine months following completion of the transaction. Similarly, stock issued in transactions exempt under the nonpublic offering and Regulation D terms cannot, in most instances, be freely traded for three years. Unless he or she wishes to become a guarantor of the purchaser's investment, a holder seeking to dispose of such stock before the holding period expires must gain an exemption or register the stock before the transfer.

In adopting another applicable standard, Rule 145, the SEC established criteria for determining when registration requirements apply to mergers, acquisitions, and similar transactions. The SEC simultaneously developed a registration statement for stock being issued in a merger. Rule 145 also establishes certain limitations on the public resale of stock subject to the registration statement.

The requirements of state "blue sky" laws and anti-fraud provisions of the federal securities law apply to any transaction involving the purchase and sale of a security, regardless of registration requirements. When the transaction involves the sale of securities by the target corporation, or by its selling shareholders, the anti-fraud rules apply to the information furnished about the acquired corporation, even as they apply to information furnished by the acquirer. If the acquiring corporation is listed on a national securities exchange, the provisions of the listing agreement should be examined.

In stock purchases, mergers, and share exchanges, the purchaser assumes the target company's liabilities by operation of law. (Selected obligations could, of course, be shifted by contract back to the seller.) In an assets transaction, however, with the exception of certain limited successor liabilities, the purchaser must expressly assume liabilities of the seller. The value of assumed liabilities in an assets transaction will be treated as income to the seller. The purchaser will include the value of assumed liabilities in the purchase price being allocated to the acquired assets for tax purposes.

Once the purchaser decides to assume liabilities in an assets purchase, it usually will prefer to assume only liabilities specifically disclosed and accepted in the acquisition agreement. In many instances, the purchaser will assume liabilities set out in the balance sheet accompanying the agreement and those liabilities arising in the ordinary course of the seller's business between the balance sheet date and the closing date. Obligations under scheduled leases and contracts also are customarily assigned at closing.

Dealing with contingent liabilities

The foregoing assumption provision does not transfer all of the seller's liabilities to the purchaser of assets. Contingent product warranty claims and other contingent liabilities may not be reflected on the balance sheet. If the purchaser is assuming contingent liabilities, the acquisition agreement should address this matter explicitly. Moreover, the purchaser should insist on full disclosure of any such liabilities.

If a seller can more effectively eliminate contingent or other liabilities post-closing that the purchaser would otherwise assume, the purchaser could provide the seller with specified funds to retire the liabilities. Examples of such liabilities include:

☐ Contracts the purchaser intends to terminate that

involve parties with whom the seller has other ongoing business relationships; and

☐ Pending litigation that is unlikely materially and adversely to affect the acquired business.

The purchaser usually will require the seller to retain its income tax liability. An assumption of tax liabilities effectively would substitute the purchaser for the seller in any audit of the pre-closing tax returns of the acquired business. As with any other liability, the purchaser can require the seller to utilize sale proceeds to discharge any tax liabilities or to place the requisite funds in escrow at closing.

Keeping abreast of applicable laws

When purchasers assume liabilities, they often must confront the issue of requests to alter existing guarantor arrangements for target company debt. Principals of the seller that personally have guaranteed obligations of the acquired business rarely wish to continue as guarantors after closing. If the purchaser assumes the underlying obligations, the guarantor should be entitled to have his or her guarantee released as a condition of closing. The parties often accomplish this by arranging to pay off the underlying obligation or by designating a substitute guarantor, such as the parent corporation or a principal of the purchaser.

Even when the purchaser does not assume liabilities, due care must be exercised. Bulk sales statutes, fraudulent conveyance laws, and various court-imposed doctrines may place transferee liability on the purchaser, unless the seller utilizes sale proceeds to retire the nonassumed liabilities.

Even when transferee liability does not exist and the purchaser has no legal requirement to satisfy the seller's creditors, the purchaser should develop a strategy to preserve the goodwill of the acquired business. That strategy could include securing a covenant by the seller to satisfy all or certain nonassumed liabilities at or before the closing and to indemnify the purchaser for any loss suffered because of the seller's failure to extinguish those debts. Again, the purchaser could require that part of the purchase price be put in escrow until the seller fully discharges the specified debts.

Determining the price and the means of payment are among the most challenging and complex aspects of private company acquisitions. Careful planning and the constructive interaction between the parties, as well as their legal and financial advisers, will yield the best results. ■

How Seller Financing Can Work For the Buyer

Michael L. Sklar

While not easy to develop, seller financing techniques can help win a deal at an acceptable price.

Seller financing is one of the most overlooked sources of financing to help get a deal done in the mergers and acquisitions market of the mid-1990s. At a time when prices are starting to creep up and there are pressures to pay a lot of money, seller financing often can take a buyer beyond the level that outside financing sources are willing to put on the table. As a result, seller financing can win the deal and push the buyer over the top to beat out the competition in an auction situation.

Some primary examples of seller financing that can be useful in the deal structure include:

- Issuing preferred stock to the seller;
- Deeply subordinated debt, which the seller will take as a long-term payment or a deferred payment;
- Earn-outs; and
- Restricted stock that the buyer may offer to the seller.

Versatility of Preferred Stock

Preferred stock in the hands of a seller has certain advantages, both to the seller and the buyer.

On the buyer's side, if loan covenants are written correctly, the lenders will look on the preferred as equity. However, the buyer really hasn't given up true equity, unless, of course, conversion rights are associated with the preferred stock. If so, the buyer needs to be concerned about the clock ticking away when those

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BETS ON THE FUTURE

Seller financing, which comes in several variations, can be a tough proposition to get into a deal structure when a seller wants all cash. But kickers and deferred payments may be worth trying, especially when outside financing won't cover the purchase price or competitive bidding has pushed the price beyond the buyer's means. Prominent seller financing techniques include preferred stock, deeply subordinated debt instruments, restricted common stock, and earn-outs.

While each format has merit and can provide an edge in getting the deal done, the warning is that none comes free of baggage. Earn-outs can be especially nasty if not drawn properly, and there may be liquidity problems with debt and stock. It is wise to be aware that, ultimately, dividends and interest often have to be paid in cash.

conversion rights ripen. That should serve as a warning to buyers that the benefits of preferred stock are accompanied by strong liabilities. If the clock ticks down and the buyer is not able to pay off or call in the preferred shares with callable rights, the holders — which could be the seller or an outside financing source — may be able to exercise the conversion rights and significantly reduce and dilute the equity interests of the new owner.

The preferred stock can be payment-in-kind (PIK) preferred. When it is time to pay dividends, the issuer of the preferred can, as an alternative or as an option, issue more preferred stock or increase the face value of the preferred shares rather than pay in cash. However, cash dividends paid between corporate entities are 100% tax-free, if the unit paying the money is a wholly owned subsidiary, or partially tax-free, if it is less than a wholly owned subsidiary. If this arrangement is structured correctly, cash dividends on preferred stock sometimes can be more attractive to the holder of those preferred-stock shares than interest on notes, since some portion if not all of the dividends received can be excluded for income tax purposes. Of course, the payments are not deductible by the issuer.

Subordinated Seller Debt

As for deeply subordinated seller debt, a personal experience will demonstrate its viability in getting the deal. I recently was involved in a competitive bidding situation in which the deal was valued at about $55 million. What got the deal for the buyer was its willingness to tack on a note that was tied to earnings.

Under the terms, if the target company meets certain earnings goals, the note gets paid in five years and the interest accumulates on an annual basis. If the earnings goals aren't met, the note doesn't get paid. It wasn't a major portion of the purchase price but it was enough to push the buyer ahead of the competition.

Now these notes are, to reiterate, deeply subordinated and junior to other debt instruments in the deal structure that usually are provided by outside financiers. The seller winds up with a piece of paper that really isn't worth very much unless the deal succeeds and the performance projections are met. Nevertheless, it is debt, and the seller knows that if the projections are met, he is going to get paid at some time. In some respects, these notes are, for many sellers, better than stock, better than equity, and better than preferred stock.

The Earn-Out Balancing Act

Earn-outs are particularly interesting and useful in situations in which the target is going through a significant growth phase and there is some lack of predictability as to whether performance projections are going to be met. An earn-out can be a hedge for the buyer, i.e., if the projections aren't met and the business doesn't reach the expectations the seller has outlined, the buyer is protected. On the other hand, if the projections are achieved, the seller has a nice up-side potential but the buyer hasn't given away long-term equity.

There are, however, some peculiarities and features about earn-outs that need to be kept in mind. One is that if an earn-out makes up a significant portion of the purchase price, sellers generally will want two very

In some respects, notes are better than stock for many sellers.

important safeguards. The first is an agreed-upon business plan so the seller knows that capital is going to be available to finance expansion plans and that the buyer is going to support the total post-deal effort. If the buyer can get diverted, buy other businesses, and avoid commitment to supporting the acquired company, the seller is going to be less interested in the earn-out and the deal may not get done.

Another obviously important portion of an earn-out arrangement is that the seller generally will want its management position very well protected. It is a rare seller that will agree to an earn-out and then turn the business completely over to the buyer and the new owner's management team. Therefore, a buyer that is thinking about using an earn- out, particularly for a business that is growing very rapidly, had better be ready to deal with incumbent management and take a real hands-off approach to the business.

Buyers should be warned that the benefits of preferred stock are accompanied by strong liabilities.

A lot of buyers are not willing to be that remote — financial buyers more so than strategic buyers. But financial buyers are generally less interested in explosive growth businesses. The financial buyers that I have worked with certainly want growth because that is how value is added. But they prefer businesses that are relatively predictable and that generate cash flow that is certain and secure. So, strategic buyers that use earn-outs may have to be willing to put aside their desires to manage and let the seller manage the business.

One way of meeting the objectives of both sides is to move the earn-out up the income statement to perhaps a sales royalty arrangement. The seller can feel a little more confident about relinquishing control of the business. The former owner will be compensated on basically a top-line number which the buyer has every incentive to grow.

But that is often a source of considerable tension between buyers and sellers in negotiating earn-outs. At what point on the revenue stream and/or the profit-and-loss statement is the earn-out percentage going to apply? The negotiating tensions mount as the two sides move closer to net aftertax profits as the basis for the earn-out. The seller is particularly concerned about keeping the earn-out criteria pure and free from the buyer's overlay of overhead and capital costs to finance new facilities and expansion. Real tension goes on, not only during deal negotiations but often during the entire period of the earn-out after the deal is closed. Earn-outs are tricky but useful in the right circumstances.

A very important concern with earn-outs is the tax issue. If too great a proportion of the purchase price is in an earn-out and the buyer turns over post-deal management and operation of the target to the seller, it begins to look a lot like ordinary compensation and not a true purchase price. That can cause havoc with the target's p&l statement and give the sellers a rude awakening if they find out they must pay ordinary income tax rates rather than capital gains on the proceeds of the earn-out.

What about using stock as a means of funding a purchase price? Stock can be particularly valuable when the buyer is a publicly held company that can leverage the value of the shares. If the public company is doing well and its stock is trading at 10, 12, or 15 times earnings, it is probably going to pay a lot less of a multiple for the earnings of the acquired business. In fact, the earnings of the acquired business may be translated eventually into the value of the stock in the marketplace.

In the context of seller financing, generally restricted stock, or unregistered stock, is used. Occasionally an acquiring company will register the stock that they give to the seller with the Securities and Exchange Commission. But usually the currency is restricted stock, which the seller, under the SEC's Rule 144, must hold for at least two years.

When that two-year period expires, the seller can begin to sell the shares on a piecemeal basis, or leak them out into the marketplace, without filing a registration statement with the SEC. Sales are restricted to the greater of:

- One percent of the outstanding traded stock sold in any four-week period, or
- The average number of shares traded in the four weeks immediately before the sale by the holder of the restricted stock.

However, the seller may request registration rights for the stock it receives. If the buyer later decides to file a registration statement and issue new stock, the seller can piggy-back its restricted stock on the registration statement and sell out in a secondary segment of the public offering. The stock can be sold in one swoop rather than being dribbled out in phases.

A third device for handling restricted stock is a shelf registration. There is a special procedure under applicable SEC rules for the buyer to file a shelf registration statement, which is something less than the S-1 filed for public offerings and doesn't specify a time for the sale. The statement must be updated periodically so that there is full disclosure.

With the self registration, the holder of the restricted stock can, on notice to the buyer of the business and on delivery of a prospectus, sell the stock even if a full-blown registration statement is not in place. ■

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Merger Syndrome: Stress and Uncertainty

Mitchell Lee Marks and Philip Mirvis

Fears and uncertainty frequently plague employees of acquired companies who must deal with new systems and please new bosses. If ignored, this merger syndrome can foul even the most carefully developed business combination. The first article of a two-part series suggests ways to manage syndrome-related stress.

CORPORATE EXECUTIVES and consultants in the field of postmerger integration are starting to recognize the emergence of the "merger syndrome" as a primary cause of the disappointing outcomes of seemingly otherwise well-conceived mergers and acquisitions. Basically, the merger syndrome is triggered by the often unavoidably unsettled conditions in the earliest days and months following the combination and encompasses the executives' stressful reactions and development of crisis-management orientation. The bottom line, if the syndrome is allowed to go unchecked, can be marred performances and poor financial and operational results.

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Ironically, the executives seemed to be ahead of the experts in identifying the merger syndrome and its perverse impact. The phrase was coined not by us or others who have specialized as consultants in postmerger integration but by corporate officials who utilized it with impressive, if unscientific, regularity in interviews conducted during our research into methods for smoothing the integration process. And in one of our most striking discoveries, we found that the merger syndrome arises even when the partners have taken some care to devise a thoughtful integration designed to minimize upheaval and provide due consideration for its effects on people.

Identification of the merger syndrome adds another dimension of concern to a process which traditionally tried to explain merger failures in purely business terms and only recently began focusing on the people aspects, although casting them in such highly generalized terms as "culture." More important than merely identifying the merger syndrome, we will discuss its roots, causes, and manifestations while outlining the methods that can be used to cope with it.

What creates the merger syndrome? For executives it is a combination of uncertainty and the likelihood of change, both favorable and unfavorable, that produces stress and, ultimately, affects perceptions and judgments, interpersonal relationships, and the dynamics of the combination itself. In companies, the syndrome is manifested by increased centralization and lessened communication that leave people in the dark about the combination and fuel rumors and insecurities. This often pro-

duces "worst case" scenarios that distract employees from regular duties and cause them to be obsessed with the impact of the combination upon themselves and their work areas. All of this hampers postmerger negotiations and integration, reduces productivity, and contributes to the turnover of key people.

Obviously, the merger syndrome is a total anathema to a successful integration. The postmerger period requires that executives be at their peak and that their companies perform at levels of efficiency that are reassuring to customers, the financial community, and, of course, sometimes wary executives of the acquiring concern. But executives are people and their natural response, and the natural tendency in the firm, is to experience stress and run in a crisis mode at the expense of both individual and organizational performance. Sadly, this can add further stress and create further crises in the firm.

Consider the following two vignettes which will serve as centerpieces for further examination of the syndrome and its antidotes:

Case I: A small manufacturing firm, the leader in its market and growing at an annual rate of 15–20 percent, was the target of an unfriendly takeover bid. The president investigated the bidder and discovered it to be an unsuitable merger partner. Though wanting to remain independent, the president was advised that finding another buyer would be the only alternative to the unfriendly takeover. A retail and food-service conglomerate, which had discussed the possibility of a merger with the manufacturing firm a few years earlier, agreed to purchase the company in a white-knight acquisition.

An unexpected backlash

By all accounts, the acquirer followed the classic conglomerate combination pattern, seeking detailed information on the financial results and plans of the manufacturer, and imposing only those systems and controls necessary for its financial integration as a subsidiary. Because timing precluded a comprehensive premerger analysis, the buyer intensified the postmerger scrutiny. In addition, bureaucratic insensitivity on the part of the acquirer made the few controls that were adopted seem like more of an imposition than they were. But the acquirer made no personnel or operational changes and, from an objective perspective, acted with prudence and good intentions. The subjective reaction of key executives in the manufacturer was, however, quite different. Unprepared for and shocked by the unfriendly bid, these executives came to the mind that their "white knight" actually posed a formidable threat to them. Top managers met on an almost daily basis to devise strategies to resist intrusion and preserve their company's systems and its unique character. Mid-level managers took their cue and proved to be "non-compliant" in dealings with their counterparts at the acquirer. Sales and productivity dropped dramatically.

Loss of independence

Executives in the manufacturer were suffering from the merger syndrome. Their sense of loss over the independence of their company clouded their judgments of the acquirer and colored dealings with its executives. The syndrome also may have affected the acquirer as its financial people began to question the wisdom of its investment and called for cost cutting and significant budgetary reallocations. After 10 years of profitability, the manufacturer posted its first annual loss immediately after the merger.

The acquired firm's top management reacted by enlisting consultants to diagnose the exact causes of the downturn in productivity. The results of an employee attitude survey revealed strong feelings among the general workforce that top management had grown less interested in employees' well-being since the acquisition, that — contrary to the preacquisition climate — top management cared more about profits than people, and that top management's actions were motivated by a desire to please the new owner rather than promote employee welfare. Top management was surprised by the survey results, yet also recognized that their obsession with managing the merger came at the expense of maintaining close connections with employees. A psychologist was called in to work closely with the members of top management to help them work through, individually and collectively, the emotional impact of the acquisition. Concurrently, executives moved to restore relations with members of the workforce through increased communication, meetings, and informal interactions. The results were dramatic. Performance improved in the following quarter and the company returned to profitability in the very next fiscal year.

Case II: Two equally sized banks merged in a region of the country where such combinations were just starting to develop. The leaders of both institutions were rookies in the merger game and they developed a cautious postmerger integration plan that called for the eventual consolidation of the data

processing, product development, financial control, and treasury functions. But, to prevent upsetting customers, all branch banking operations were to remain intact.

Soon after the merger was announced, rumors began to circulate among employees that half of all branches were to be closed and branch personnel such as tellers, loan officers, and branch managers were to be laid off. The months following the merger were marked by a sharp increase in the absenteeism rate among branch personnel. For those employees who did come to work, performance suffered and the customer complaint rate nearly doubled. Eventually, about a third of all branch personnel voluntarily resigned. The costs to the newly merged institution to hire and train personnel, and in the loss of business resulting from the poor performance, were substantial and led to a crisis-marred beginning to a merger which, supposedly, had been planned to avoid such upset.

Are these two cases unusual? Our research, involving interviews and observations during the first months of several such combinations, and our consultation with firms at all phases of the merger process, indicate that they are not unusual at all. Symptoms of the merger syndrome appeared in the more than one dozen mergers that we analyzed and worked on as consultants. We found repeatedly that stressful reactions and crisis management are natural and characteristic responses to mergers and acquisitions. Moreover, such reactions have affected the course of the combination and the performance of the firms involved.

Executive stress in a combination

What makes a merger especially stressful for executives? For one thing, there is more work to do and less time to do it in. The sheer amount of work involved in combining firms, gathering and digesting enormous amounts of information, and reaching rapid decisions is overwhelming and absorbs great amounts of executive time and energy. Second, there is a great deal of uncertainty as to the future. Questions abound in a combination for which there are no given answers: How will reporting relationships be structured in the new organization? Which firm's policies and procedures will be followed? How will pay and benefits be affected? Will decisionmaking practices change? Will previously promised promotions or job assignments be honored? How will redundancies in staffs and functions be resolved? Will people leave or have to be let go?

Finally, this is a time of insecurity. For executives there is, of course, the immediate insecurity of job loss due to redundancy or simply not fitting into the new organization structure. There is also the insecurity of having to demonstrate one's value and skills to new superiors. We have found many executives who lament that their track records account for nothing following a combination, and they are depressed by the thought of having to prove themselves again. Job insecurity also permeates an organization and leaves executives with the responsibility to defend their people. Top managers can be caught in a classic double bind: A natural response to uncertainty and insecurity is self-protection; yet the requirements of a top manager's job also include protecting other people.

Subjective perceptions take control

A merger or acquisition changes people's accustomed work arrangements, demands more time, poses countless vagaries and uncertainties, and can threaten jobs and people's self-esteem. Basic research on stress highlights several factors that add to the stress of a combination.

First, the stress of an event is determined by people's subjective perceptions, not by any objective reality. In the manufacturing case, the upset caused by the unfriendly bid seemed to carry over into executives' dealings with managers from the white-knight acquirer. Seemingly sensible requests for information from the acquirer were treated as intrusions by the manufacturing executives and proposed changes were viewed as incursions into their own terrain. In the bank case, branch personnel heard rumors of layoffs in some functional areas; anticipation of layoffs in the branches, therefore, became the basis of their own perceived reality. This was contrary to the objective reality that there was no planned change in branch operations.

Stress increases people's vigilance in gathering information but can lead them to simplify and distort what they hear. Planners of the postmerger organizations not only must contend with expected levels of anxiety and inevitable rumors, but also with people's perceptions of what "might" happen based upon horror stories from other situations. It is not uncommon for employees in merging or acquired firms to circulate tales of bad personal experiences in previous combinations, or about friends or relatives whose entire plant or division was closed down after a takeover. Indeed, in the manufacturing case, one executive who had logged experience in con-

glomerate mergers convinced his peers that the acquirer's bureaucracy would bury their firm in standard procedures. Media reports on business combinations often focus upon the sensational and unsavory cases. Bank employees had heard some sensationalized stories involving the consolidation of branch systems in other regions of the country and that contributed to their perceived expectation of massive layoffs in their firm. Though having no bearing upon a combination at hand, such experiences and media stories can color people's views of their situation. Under stress, people are especially attentive to hints of "bad news."

Second, the stress of an event is determined by the amount of change it implies, not necessarily whether the change will be beneficial or detrimental. Stress research shows that marriages and births can be just as stressful as divorces and deaths. Both disrupt the status quo, entangle family and friends, and require that people adapt to new and different circumstances. We have found that most business combinations are seen by employees as a mixed bag of costs and benefits. At the manufacturer, for example, there were, despite the resistance tendencies, simultaneous anticipations of more growth and more career opportunities for executives, as well as more job security in the ranks. Managers recognized a loss in autonomy, however, and employees worried that some of the company's participative, people-oriented emphasis would be lost. In addition, there is the potential for creating winners and losers in the executive suite. Indeed, at the manufacturer, key operational and financial managers were seen as gaining power in the combination while the president and officers in other functional areas were seen as losing some.

Cascading of minor changes

Furthermore, the effects of stress are cumulative. In a combination, a series of small, seemingly innocuous changes can add up to a large and significant change in the eyes of people. At the bank, a change in name, in central structure and operations, and in the benefit plan created for branch managers and personnel, stimulated fears of wholesale change in the way business had been done. At the manufacturer, changes in some systems and procedures came to be equated with a change in a way of life and they were resisted by top managers.

The stress of a combination can take its toll. Top managers at the manufacturer reported nightmares and sleeplessness. Some had given up smoking but started again. Sleeplessness and edginess added to their stress. At the bank, some key managers left, adding to the burdens of those who remained. Personnel looked to the surviving executives to save the branch system. Rather than put up with the added stress, still other managers looked for new jobs.

Coping with stress in a combination

Although stress can be debilitating, it can be activating and, when effectively managed, it can be channeled into productive, even creative, work. People have a natural capacity to cope with stress. We have found the familiar fight/flight reaction to stress in postmerger situations. Executives either may become excessively aggressive in dealing with their counterparts or withdraw their energies and attentions. This coping pattern protects them but it can also hamper the combination of firms. We also have found executives taking steps to cope with the stress of a combination more proactively, with an eye to accepting, managing, and learning from their stress, and using what they learn to manage themselves more effectively.

A key factor in determining the stress of a combination is the degree to which executives are both strategically and emotionally prepared for its impact. It would seem obvious that, given enough time, executives in combining firms would proactively plan the integration of their organizations. Yet, we frequently have observed them focusing primarily on the financial terms of the combination and neglecting consideration of new management responsibilities and reporting relationships. Some of this is to be expected as firms may want to leave themselves room to maneuver and let such responsibilities and relationships evolve. Our judgment, however, is that such deliberations prove so traumatic and evoke so much conflict that executives have a tendency to put off final decisions. This, of course, adds to uncertainty and insecurity and truly charges such issues when they are tackled after the sale. Research suggests that companies that are able to preplan executive roles in a combination are more likely to retain wanted personnel and better prepare them to fill their new roles.

Emotional preparation is another matter. It is difficult to anticipate how executives will react to a combination. Research on hospital patients shows that when they are forewarned of the pain of an operation and given a realistic portrayal of their recovery, they heal more quickly and have fewer complications. This may have two implications for

management of combinations. First, it would be helpful to prepare executives for the burdens and intensity of a combination before one is underway. Several universities and educational centers, for example, run merger workshops or simulations that prepare executives for both the strategic and emotional demands of a combination. Such preparation is likely to leave executives better able to handle a combination of their own firm. Second, it would be useful for executives to have a realistic preview of how a combination might affect them. We have worked with executives to build "best" and "worst" case scenarios for coming combinations and to evaluate how they might respond to either of them. We have also helped them to "reality test" the most dire, and the most desirous, scenarios to develop a more realistic picture of what is ahead.

This methodology was used in trying to help executives of the acquired manufacturing firm prepare themselves for emotional demands. Some kept diaries of their reactions to unsettling events and these personal accounts became the bases for ongoing examinations of how the executives were coping with stress and how they could be appropriately counseled. One result was that, in spite of all the initial turmoil, management turnover in the longer run was substantially minimized. In that respect, the manufacturer stands in stark contrast to the bank which did not conduct an examination of stress reactions, nor prepare the branch system with a realistic portrayal of possible and probable changes. Personnel were left to consider rumors, horror stories from other combinations, and the worst case scenarios of layoffs and branch closings. Promises that "nothing would change" sounded empty and did not prepare people for the changes that indeed might eventually occur.

Personal assessment

While preparation can ready executives for a combination, ongoing personal assessment is needed for effective stress management. Our research has shown that people see pluses and minuses in any combination. A natural tendency is to personalize this calculation. Executives focus initially on their jobs, then their careers, income opportunities, responsibilities, reporting relationships, and how any changes might affect their spouses and families. Inevitably, they anticipate losses and gains, but most of all they see risk, both in staying and in seeking employment elsewhere.

A combination provides an opportunity for executives to examine their own risk propensity, to rethink career options taken, and to preview alternatives for the future. In short, it is time for self and career appraisal, and for counseling. This serves two functions. First, counseling can help to distinguish for executives the real from the imagined costs and gains of a combination. Research on people under stress shows that they often magnify the negative aspects of a situation and overestimate the likelihood of negative occurences. Second, counseling can help executives clarify their own wants and needs and their career aspirations.

Disloyalty may be implied

Despite executives' needs to project the impact of an acquisition or merger and to clarify career options and alternatives, we often have found their firms to be unresponsive to such concerns. For example, firms often delay decisions over management roles and reporting relationships and instead issue paternalistic dictums that nothing will change. Beyond this, they often communicate the message that self-assessment and career planning are signs of disloyalty.

The reality, of course, is that many prepare resumes, are contacted by head hunters, and exchange career confidences with a few trusted friends. All of this takes place in the organizational underground and is deemed an illegitimate and unwanted activity. As a result, personal assessments of possible loss, gain, and risk often are uninformed, and valuable executives lack the counseling they need in making major career decisions.

Who leaves a company during a combination? There is a popular, though erroneous, belief that the poor performers, fearful that their deficiencies will be noted and that they will lose clout and responsibility, are most likely to voluntarily leave. In fact, anecdotal evidence suggests it is often the best performers, those who are most marketable and who enjoy the most career options, that are likely to leave first. Unwanted turnover is costly during a combination. The costs of recruiting and training replacements are substantial and the added burden on managers takes time away from other valuable activities. If replacements are needed quickly, hiring decisions can be hasty and new personnel may not be fully trained.

Employees base their assessment of the costs and benefits of a merger to their own job or career on the information available. In many mergers, such as the bank combination, executives become so in-

volved in their own reactions that they lose touch with the needs of subordinate employees. Without official word regarding what changes to anticipate, employees must rely on rumors, media accounts, and past personal or vicarious experiences. These sources tend to produce worst case scenarios which emphasize the negative aspects of a merger.

Executives must go out of their way to counteract these dubious sources of merger information with formal and valid information. The bank management team learned well from the mistakes made in the first merger experience. Psychologists were called in to design an employee merger-communication plan early in the negotiation phase of a subsequent acquisition. Through formal meetings with all members of the workforce, informal discussions with personnel, the company newsletter, and press releases to the local media, the bank's officers spelled out the exact details of the integration plan. Unlike the previous merger — and despite the fact that some layoffs were announced — there was no significant increase in absenteeism or customer complaints following the acquisition. Financial performance reached premerger expectations.

Team building

Stress can make or break a management team during a combination. There is a natural tendency for groups under stress to band together. At the same time, the personal opportunities or costs of a combination can divide a group and leave "every man for himself." Our research has shown that executive teams serve valuable functions for their members during a combination. For one, they can prepare members for stresses and help to project a more realistic scenario for the combination. Second, they can be a source of social support for people during the transition period. This latter function is particularly important when an executive group experiences the combination as a loss.

We have studied instances in which executives believed that their company's identity would be lost in a combination. Accordingly, they had a need to "grieve" the loss of their company, much as one would grieve the loss of a loved one. Such a grieving pattern follows the contours of reactions to death so ably specified in the work of Elizabeth Kubler-Ross who studied the reactions of terminally ill patients and their families and found repeatedly occurring stages of reactions.

First, there is denial of the loss. Executives may fantasize that an unwanted bidder will withdraw its bid or that stockholders, out of loyalty, will not sell. This is followed by a period of anger which could be directed at an acquiring firm or even at fellow executives for failing to counter the bid or to implement defensive measures. Next is the stage of strategizing and bargaining. Unrealistic schemes for maintaining autonomy and influencing the other party can be developed in this period. Finally comes the stage of acceptance. Only at this point are executives ready to realistically prepare for combination.

Executives often grieve in isolation when they sense a loss of their firm. This can separate individuals and divide a group. It can also lead to jockeying for power once the combination begins and the devaluation of those who have not accepted that changes are inevitable. We found a pattern of grieving in the manufacturer we studied. Significantly, the top executives met collectively, at a grieving meeting, to share their losses, to work through their anger, and to develop a more proactive strategy for dealing with their new parent company. The management team met throughout the first year of the combination and came to see their defensive strategy as unproductive. One of them stated at a team meeting: "The enemy is us." By the end of the first year the group had reached a state of collective acceptance of the acquisition.

Interestingly, there also is a tendency for companies that gain in an acquisition to lose team cohesion. Staff personnel can impose controls without the knowledge or assent of group managers as the thrill of power supplants any coordinated approach to managing a subsidiary. An absence of contact between the team that negotiates the sale, comprised of staff personnel, and the team that executes the combination, mostly line people, often creates frictions. These groups simply have different interests in the combination and can add to confusion and uncertainty.

In the end, the task of managing stress is a function of corporate management. Executives have two major tasks in a combination. One is to manage the combination with a partner and the other is to manage their respective organizations during the combination period. This requires that executives not only build their own management team to handle the stresses and demands of the tasks ahead, but also that they reach out to their organizations and to their partners to manage the transition period. ◻

Dr. Marks and Dr. Mirvis will discuss crisis-management aspects of the merger syndrome in the Fall 1985 issue of *M&A*.

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SHOPPING FOR COMPANIES

By William W. Bain Jr.

The business press is an avid chronicler of failed mergers and acquisitions. The resulting impression is that an executive who embarks on an acquisition is little better than a compulsive gambler throwing his money away trying to beat the house odds.

There are, of course, significant data supporting this viewpoint. Studies show that a dollar invested in an acquisition has only about a 30 percent chance of creating real economic value—and some who have looked at the record say the success rate is even worse. A craps game offers far better odds of winning.

Yet merger and acquisition activity continues at a high level. American companies laid down some $200 billion last year to make more than 2,500 acquisitions. In Europe, there has been a dramatic increase in M&As. Merchant banks in the United Kingdom, for example, have begun to assume the role of deal-maker first created by U.S. investment banks. The total value of deals there in 1985 was £7.1 billion, the highest total since 1972, adjusted for inflation.

Of course, the M&A-gambling analogy does not really hold up. Gamblers are always at the mercy of the house odds, while companies can actually turn the acquisition odds in their favor. A few years ago our firm took a close look at some companies that, through acquisitions, had grown, increased their profitability, and achieved sustainable improvements in their competitive positions. A short list of those that have built substantial corporate value this way would include Heileman Brewing, James River Corporation, Flowers Industries, and the Dun & Bradstreet Corporation in the United States, and such firms as Esselte, BTR, BSN, and Hanson Trust in Europe.

We have attempted to distill out the elements that made these companies successful. Over the past two years, we have assisted clients in some 65 acquisitions in the United States and Europe, working on transactions that involved some $15 billion. Our role is not normally that of deal-maker. Typically, the first phase of our work involves setting strategy, screening acquisition candidates, evaluating them, and helping to determine the value. Structuring the exact terms of the offer and making the legally mandated inspections are areas in which investment bankers, law firms, and accountants have the appropriate expertise. We are often involved in the next stage: helping integrate the new company into the acquirer's strategy. We're still learning, but at this point, I believe we do have a set of working principles that serve our clients well.

1) Weigh an acquisition carefully against all other strategic options for creating long-term shareholder value.

Mobil buys Montgomery Ward to establish a beachhead in a business with faster growth than oil. Coke buys Taylor Wine to get into a fast-growing business in which it can apply its vaunted marketing expertise. Fluor Corporation buys St. Joe Minerals to make good use of extra cash and diversify into a supposedly countercyclical industry.

Each company had plausible justification for making its acquisition. And each now almost certainly wishes it had figured out some other way to achieve its objective.

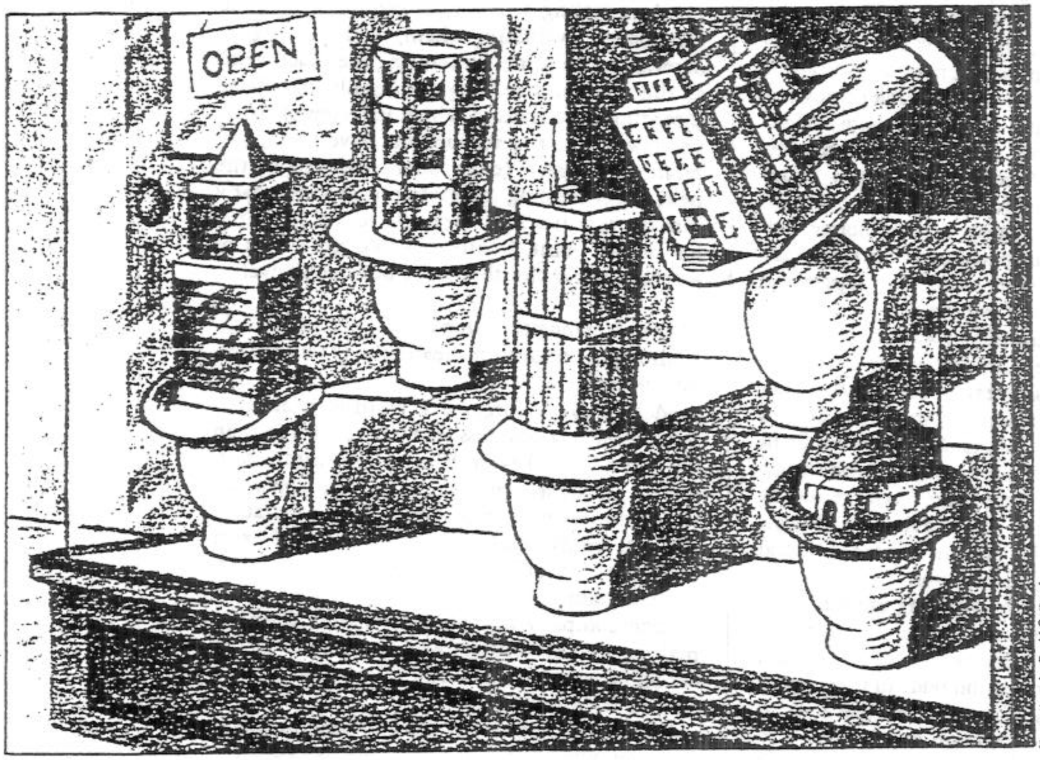
When an acquisition that looked plausible does not work well, it is usually because the acquisition was not consistent with the buyer's long-range strategic guiding principles. The point is, an acquisition may look like a good opportunity to accomplish some operating goal easily and quickly. But the chances of making the acquisition do what it is supposed to do are minuscule when the acquired company is a poor fit with the parent company's basic corporate strategy. That strategy, carefully thought through and defined, may dictate an entirely different kind of acquisition, or none at all.

The tremendous importance of core strategy is borne out by the experience of most companies that have built value through acquisitions. They have typically done it deliberately, over the long term.

At Dun & Bradstreet, acquisitions accounted for some 80 percent of the company's total reve-

William W. Bain Jr. is president of the consulting firm of Bain & Company Inc.

What appears to be a bargain may turn out to be a poor fit for the acquiring firm. Ten caveats for the corporate emptor.



Illustrations by David Gothard

nues in 1984. The revealing figure here is that the acquisitions were made over 25 years. The success of the acquisition strategy at Dun & Bradstreet is seen in such figures as growth of the market-to-book value ratio, which in 1985 was two and a half times greater than that of the Standard & Poor's 400.

At BTR, a British conglomerate, growth in the earnings from base businesses was only 10.2 percent from 1973 to 1983, while acquisitions earnings grew by 22.7 percent. A planned, sequential acquisition program over a period of 16 years strengthened their core businesses and brought them into market leadership in new areas.

The key factor in the success of these and other firms is that they had a clear vision of their corporate strategy, they weighed their options, and they chose acquisition as the means of getting where they wanted to be.

2) Actively look for a company to buy, rather than trying to save money and time by waiting for a seller to come to you.

The typical merger or acquisition begins with an intermediary, usually an investment bank, approaching several prospective buyers to interest them in a company or a division of a company. Whatever the circumstances, the prospective acquirer is immediately at a disadvantage.

The company that is approached has been targeted by the seller, which probably has only a superficial understanding of the targeted company's business. Thus, there's a better than even chance that the firm for sale does not fit the prospective buyer's strategy. What is more, the company is for sale for a reason, which almost certainly insures that an acquirer will be buying a headache of one kind or another.

The acquirer may not mind buying a certain

type of headache, but there probably won't be time to make a thorough examination of the company to determine just what that headache is. Bendix, for example, took over Warner & Swasey in a high pressure white-knight rescue—only to discover later that W&S was lagging far behind the Japanese in product development.

By contrast, if a company has an acquisition strategy, it can seek out the kinds of companies that fit that strategy and take its time in evaluating them. Sara Lee spent 16 months studying Hanes before buying the company—and the combination has been a success.

Even when a firm chooses not to make an active search, the process of setting strategy will give it a headstart in making a quick, effective evaluation when an acquisition candidate presents itself.

3) Invest plenty of effort in screening and establishing priorities among acquisition candidates.

The screening process, done properly, can be a very large project. In a recent search, we began by screening thousands of companies on the basis of the business they were in, their size, and their market value. That left us a list of 219 possible candidates. We assigned each of them a priority on the basis of potential for market growth, profit improvement, and cost sharing; we also did a rough estimate of the probable price versus the net present value of future cash flow. That got us down to 59 companies. A management review and a close look at these companies' businesses left 35 possibilities. Detailed analysis of the companies, including their position versus their competitors, got the list down to 17. Of these, 12 were selected as attractive enough to contact about a possible merger.

Despite the news media's fascination with takeover battles, some 85 percent of acquisitions are initiated by the sellers.

That is the short description of the screening process. The "long form" would contain the details, such as a careful analysis of acquisition candidates' technological position, product quality, worldwide cost position, opportunities for cost sharing and profit improvement, and potential "experience-curve" advantages. We would also develop forecasts of costs and prices, capital needs, and future cash flow, and study such factors as the intentions of competitors and the regulatory environment in the particular business.

Of course, many companies do at least some of these analyses before making an acquisition—but too often, the analysis comes after the buyer has already been approached. The company cannot be sure it is looking at the best of all possible candidates, and the time for investigation is limited. Under pressure, the company may skew its basic strategic criteria to fit the acquisition, rather than make certain that the acquisition fits the strategy.

4) Start with the knowledge that buying an industry leader will be extremely difficult. But don't settle for anything less than a company with a fighting chance to become a leader.

If so many acquisitions run into problems, why not start with the rule, "Buy nothing but the best"? Because the best companies, with rare exceptions, are not for sale. To avoid spending a lot of time and money and winding up frustrated, firms looking for acquisition candidates should include probable availability as a criterion in early screening.

What is implied here, of course, is that the companies evaluated are going to be less than top performers. But that is almost always the case, as we have seen, if a company waits for a deal to come knocking. The advantage in the active approach is that the buyer can choose its problems—and opportunities. The rule of thumb is that a candidate must have a "fighting chance" of becoming an industry leader.

Indications of this fighting chance include one or more of the following: a high-quality product, widespread consumer recognition and acceptance, a strong technological position, clear opportunities to become the low-cost producer, long-term real market growth of at least 10 percent annually, a number of competitors with no one dominant, and a high barrier to market entry. Companies that have relatively low profit rates, despite high relative market share, are particularly good candidates.

5) When you find a company with undervalued assets but whose business is completely unrelated to yours, think very, very carefully before grabbing this "bargain."

One of the most seductive traps in acquisitions is the "asset bargain," in which a takeover candidate's raw-material reserves or other tangible assets can be picked up at a price below the current market. There are two problems with this approach. First, if the market has undervalued a company's tangible assets, there is probably a good reason, and that reason is seldom long in emerging: Commodity prices plummet, or the industry runs into manufacturing overcapacity or some other difficulty.

The second problem is that the "undervalued-asset" argument is frequently used when the

acquired company's business has no significant relationship to the acquirer's business. This is a problem because one of the key indicators of whether an acquisition will increase shareholder wealth is the degree to which the two companies' businesses are related. In a study of 68 mergers and acquisitions, market value of those involving unrelated businesses had declined by an average of 4 percent two years later.

6) Make certain all the synergies of an acquisition are firmly based on shared economic systems and can be realized almost immediately.

Our study showed that there was an increase in shareholder wealth when companies' businesses were related, but it was slight. When companies had related businesses and shared economic systems as well, the increase went up by some 3 percent over a two-year period. The seven-point improvement over unrelated acquisitions suggests an enormous improvement in rates of return, given the already large size of most of the acquiring companies.

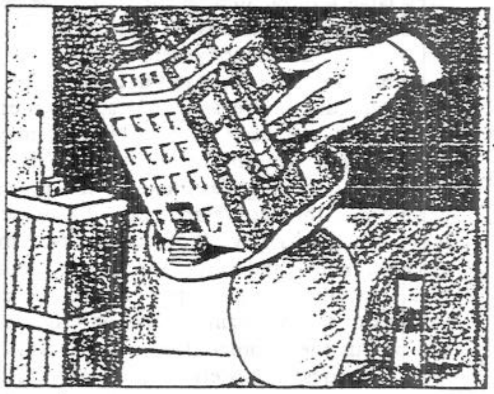
There are obvious instances of shared economics that produce significant cost reduction. When companies share a customer base or distribution system, for example, functions can be combined to rationalize costs. Some of the most successful mergers, such as those between Nabisco and Standard Brands, and Norfolk & Western and Southern Railway, have been firmly grounded on shared economics. In fact, mergers within industries generally have a high potential for success because of cost sharing. The attractiveness and feasibility of such mergers is greatly increased, of course, under the Federal Government's current close interpretation of antitrust law.

The comparatively good prospects for mergers within an industry have been demonstrated in airlines, oil, and other industries that have gone through deregulation. To survive in the newly competitive market, companies are virtually forced into mergers to improve their overall cost structure.

On the other hand, opportunities for good acquisitions within an industry don't always exist—which means that the principles of related businesses and shared economics must be applied creatively. For example, a number of public utilities, faced with slow growth in revenues, have successfully diversified. In one study, we found that the market-to-book value ratio of seven highly diversified utilities was an average of 20 percent higher than those of nondiversified utilities from 1975 to 1985, even though the diversifieds' return on sales and net plant investment was lower. These diversified utilities took advantage of their expertise and existing systems in such areas as monthly billing and crew/fleet scheduling to get into such businesses as transaction processing, time-sharing services, product marketing, fleet management, and energy-maintenance services.

"Shared economics," broadly interpreted, includes combining technology to achieve lower costs. Our own experience in this area has involved, among other things, working with a book publisher to acquire a printing firm whose advanced technology almost immediately resulted in lower costs.

The operative words here are "almost immediately." Convoluted schemes that promise ephemeral cost synergies down the road are not sufficient basis for a good acquisition, as the road



often turns out to be a primrose path.

Of course, there are some successful "conglomerates," including several in Britain. Because the British Government has raised formidable roadblocks to mergers that increase concentration in an industry, "acquisition houses" have put together groups of essentially unrelated businesses sharing few or no economic systems, and have managed to do it successfully. These companies may be the exception to the rule. But if they enjoy long-term success, it is more likely that they have followed a set of very fundamental principles in assembling their divisions.

7) Go beyond the minimum "due diligence" by going inside the target to study its strategies and its competitive strengths and weaknesses.

Believe it or not, many buyers never take a thorough look at what they are getting for their

One of the most seductive traps in buying is the "asset bargain."

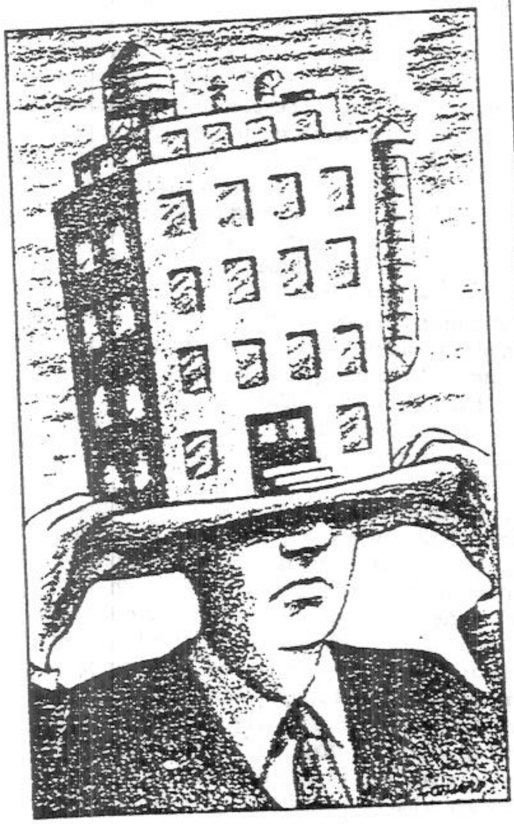
money. The typical due-diligence study lasts a week or so and may involve only cursory on-site inspections and discussions with the prospect's management personnel.

By contrast, our clients have often asked us to do in-depth internal studies lasting two or three months in order to get a complete understanding of the prospect's strategies, cost position, technical standing, research and development capability, and other characteristics. These "inside studies," done discreetly, can be a first step in a process of friendly acquisition and effective integration. With ample data on the company, the buyer is in a good position to discuss such matters as price and how the company will fit into an overall strategy.

Obviously, an internal study is not possible in all cases, especially in hostile takeovers. But even in those situations, an in-depth analysis can be done from the outside to help size up the target's strategies and competitive position.

8) Early in your approach to an acquisition candidate, begin talking about your strategy and theirs, and how you intend to fit the two together.

Begin integrating the company before the ink is dry. The "honeymoon" period simply heightens anxieties.



In our experience, the process of integrating an acquired company should begin early, even before the deal is completed. When the acquired company's management knows what their company's role is to be, and when the acquirer has their feedback on that role, the likelihood of harsh clashes later on is minimized.

Frank discussions at this point also can help smooth the path to a deal that is equitable for all parties. A buyer is unlikely to get a price that is a "steal," but a good relationship with the acquired company can prevent a bidding war.

Having arrived at a price based on information sharing, both companies understand that the price is justified only if the organizations can be integrated smoothly. One of our clients, which has been involved in a number of very successful acquisitions in recent years, adheres to the principle that it will realize the value of the transaction not by buying assets at a bargain price, but by doing a good job of integrating the acquired company.

9) Determine how much you will pay for a company based on the value created by the merger, and don't get drawn into a bidding war that runs the price up beyond that level.

Simply put, companies tend to pay too much for acquisitions. Between 1970 and 1983, acquiring companies paid premiums normally ranging 40 percent to 50 percent above the actual market value of companies they bought. The combined companies must create a great deal of added economic value to justify such premiums. Few manage to do it.

One reason companies pay too much is that they do not actively seek acquisition candidates, but wait for someone to approach them with a deal. The ensuing process will always maximize the price paid because, after all, the seller or the intermediary representing him is obligated to get the highest possible price for the company on the block. The typical scenario is a bidding war, with the price getting pumped up far above any reasonable level.

By contrast, when a company is an active buyer, it has time and can commit adequate resources to evaluating just what an acquisition is worth. It's not just a matter of valuing corporate assets. In our view, the proper method is to calculate the added value that can reasonably be expected to be achieved by combining the two companies, then use the net present worth of

that added value to arrive at a price that gives both buyer and seller a share of the expected benefits.

Walking away when the price gets too high is not easy, but it can be done, as proved by such companies as Hanson Trust, which backed away from at least one acquisition when the price became unjustifiable.

10) Rather than leave the acquiree alone to get used to the idea of being taken over, begin integrating the company as soon as the ink is dry.

It seems logical: The buyer knows that the acquired firm will have problems because of intensified competition from without and feelings of insecurity from within. So the buyer takes a hands-off attitude, and even issues statements that may exaggerate the degree of autonomy the new subsidiary will have.

Our experience indicates, however, that this approach leads to early sorrow. In a study of 55 acquisitions, we found that 49 did not produce the first-year results that could reasonably have been expected. We believe that the honeymoon is responsible. It simply heightens the anxieties, uncertainties, and inward focus of the newly acquired company. The old corporate culture weakens, and there is nothing to replace it. Suddenly, in the middle of the year or two of grace that the buyer was going to give the acquired company, the problems become so intense that the buyer finds itself jumping in to fight fires, or standing by while the situation deteriorates.

A number of acquisitions have gained dubious distinction that way. Shortly after Midland Bank, of London, took over Crocker National Bank, the latter was reporting sharp losses, which most observers attributed to Midland's hands-off policy. When Prudential Insurance acquired Bache & Company, it reportedly left Bache almost entirely alone, recognizing the potential problems in trying to marry the two companies' vastly different cultures; Bache's early performance was not good. Phibro Corporation, a huge commodities trader, took over Salomon Brothers with the intention of achieving synergy between the two companies, with each operating autonomously under the holding company Phibro-Salomon. From all reports, the synergy did not materialize, and Phibro's subsequent poor performance evidently opened the way for Salomon to turn the tables and gain control of the parent company.

It is more effective—and realistic—to take immediate steps to begin integrating the new company. After all, the buyer has purchased the company as part of its strategy, and the new subsidiary should begin to play its role as soon as possible. Even before the deal is completed, a six-month integration plan should be prepared.

Of course, integrating will mean different things under different circumstances. The buyer may want to give the acquiree a fair degree of autonomy, if that fits the buyer's strategy. For example, the British company Tilling preferred a "light touch" in managing its numerous divisions. That approach seemed to work well until the company ran into problems and was taken over by BTR, which is known for taking a firm hand in managing its acquisitions.

Integrating must be culturally sensitive. Too much interference has been cited as the cause of problems in such cases as Exxon-Vydec and Schlumberger-Fairchild.

Believe it or not, some companies buy without looking.

But those are simply cautionary tales, and they do not alter the fundamental necessity of making a newly acquired firm understand and follow its role in the buyer's corporate strategy. The acquired company's management and employees may not like the new situation, but at least feelings of uncertainty are laid to rest.

There are some key steps in integrating the new company. One of the most important should be an "audit" to develop an independent data base on such factors as the acquisition's customers, competitors, and costs. This set of facts, agreed to by the buyer and the management of the acquisition, is the foundation for establishing the common goals they will be aiming for. And the plan to reach those goals should be put in motion without delay.

Of course, the most carefully wrought integration plan could turn out to be worthless. Charles A. Lamb, director of planning at Allied-Signal Inc., has stated the situation succinctly: "No integration process can overcome the problems of an acquisition that was ill conceived in the first place."

The principal reason that so many acquisitions are ill conceived is that most companies who make them are actually assuming a passive stance. The news media's fascination with takeover battles may give the opposite impression—but the fact is, some 85 percent of all acquisitions are initiated by the sellers. The company that makes an acquisition under these circumstances is like the shopper who goes to the supermarket without a grocery list: You spend more money than you intended, and you probably don't get what you need. ■

WHARTON LIPPINCOTT

Deal Financing By Suppliers And Customers

Daniel O'Donnell and David E. Schulman

It may be good business for a vendor to help pay for an acquisition, and a prop to the purchase price if a seller remains a customer of a divested unit.

In both auction and direct-negotiation sales contexts, acquirers often conclude that the purchase price required to obtain a business exceeds their immediately available financial resources. Increasingly, successful acquirers are bridging this purchase price "value gap" by extracting financial benefits from vendors and customers in the form of vendor financing and customer supply arrangements.

Industry profitability generally is considered to be a function, in part, of the bargaining power that business firms possess against suppliers and customers. Acquirers tapping into vendor financing and customer supply arrangements to bridge the value gap are applying to acquisition financing the general commercial principles that businesses adopt in attempting to maximize profitability. While these unorthodox financing techniques may require extended time and planning by an acquirer and its counsel, they may enable an acquirer to finance a transaction that, under more conventional measures, appeared not to be financially feasible.

Vendor financing enters the deal when suppliers to the business being sold commit either cash toward the purchase or more-favorable price and credit terms to help the new owner. Supply contracts commonly are developed when companies sell former captive businesses and agree to continue purchasing products from

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STRETCHING THE DOLLARS

Acquirers that can't come up with enough money to swing an important acquisition may be able to ask suppliers and customers to help them bridge the "value gap." Vendors eager to keep selling to the target business have been putting up money, usually through a direct investment stake in the acquirer. But the more common format is to liberalize product prices and payment terms so that the acquirer can generate more post-deal cash flow.

On the other side of the value chain, customer supply agreements can help, especially when a diversified company sells a captive manufacturing business. The seller agrees to keep buying the product from its former unit on an outsourcing basis.

While these arrangements look good in getting a deal done, the warning is that they must be carefully structured to protect both sides against a host of post-deal problems ranging from solvency of the buyer to lender pressures to product obsolescence.

the divested operation under an outsourcing arrangement. Despite their financial advantages, these arrangements must be structured carefully to ensure that they are legally sound and protect both sides against post-deal backlashes and soured relationships.

The advantages of exerting bargaining power against vendors and customers in order to bridge the value gap are shown in the following hypothetical example. Assume that you are the director of development of Mix 'n Match Inc., a growing conglomerate, and you are heading the team that will pursue the acquisition of the produce packaging division of Good4U, the largest North American producer of fruits and vegetables. Good4U is selling the division to concentrate on product development and retail distribution and to become competitive worldwide in all the facets of its business. Your CEO has made it clear that, strategically, Mix 'n Match must not lose this deal.

Unfortunately, your chief financial officer says that Mix 'n Match cannot raise more than $200 million in cash for the purchase based upon current packaging division information in the hands of Mix 'n Match and its financing providers. Reliable independent sources inform you that the packaging division is expected to fetch between $225 and $250 million in the auction being run by Good4U's bankers. Thus, a value gap of $25 to $50 million probably exists.

The auction sales book provides some helpful information. The packaging division manufactures and sells cans and paper cartons used in the packaging of fruits. The division has three manufacturing facilities in the western United States and 70% of the sales are generated by an innovative, high-margin line of cans covered by a U.S. patent that stays in existence until the year 2000. These cans have recognition value in the market that is determined partly by their distinctive nature.

The division's customers are major food and vegetable growers and distributors in the U.S. and Mexico, the largest of which is Good4U, which accounted for 40% of sales in the latest fiscal year. Good4U indicates in the book that it is prepared to sign a five-year supply agreement with the winning bidder. On the supply side, the leading vendors are Metal Inc., whose shipments equal about 25% of the division's sales, and Paper Inc., whose shipments equal 10% of revenues. Good4U is Paper Inc.'s largest customer, with over 85% of such sales generated by Good4U's other business units.

In trying to close the shortfall, the first area to examine is possible vendor financing. In our example, Mix 'n Match would consider approaching existing and prospective vendors to obtain variants of the following:

- **Direct Investment** — Vendors make debt and/or equity investments in the acquirer or one of its business units. The cash flow benefit is immediate in that the acquirer obtains an infusion of cash from the sale of the securities.
- **Vending Terms** — Vendors commit to favorable supply arrangements, generally involving price and credit terms. In this case, the cash flow benefits may be obtained over time through lower prices or, as a result of "stretched payables," less need to draw down revolving credit.

There are two reasons that suppliers are willing to contemplate vendor financing. First, when a business is up for sale, existing vendors may wish to retain the business. Second, new vendors may want to "get their foot in the door" and may view a divestiture as an excellent opportunity to do so. For any number of reasons, current and prospective vendors may offer vendor financing in order to add or retain market share.

The most prevalent from of vendor financing is in the form of favorable vending terms. Depending upon the acquirer's bargaining power, the vending terms may be formalized in a long-term contract. The acquirer will want to review this with counsel, especially when its other financing sources are relying on these vending terms as critical parts of the purchaser's postacquisition cost strategy. Although less typical, acquirers increasingly are seeking and obtaining direct investments from vendors.

In the Mix 'n Match example, the two logical vendor/investors would be Paper Inc. and Metal Inc. Pre-

sumably, Mix 'n Match is prepared to solicit direct investments only if the capital that it would receive reflects below-market rates of return (e.g., for borrowings at below-market interest rates and perhaps longer amortization periods than "institutional" creditors would require) and/or would be sold at below-market prices (e.g., relatively expensive equity that implicitly prices what the vendor is paying to continue the business).

In advising an acquirer such as Mix 'n Match about possible vendor financing, counsel will want to review a number of issues, including:

Confidentiality Agreement

Customarily, sellers such as Good4U will require prospective bidders to execute confidentiality agreements under which bidders agree not to share any confidential information regarding the target business (or even the fact that a sale is contemplated) with third persons other than key employees and other permitted persons, such as financial advisers, accountants, legal counsel, and certain financing sources. Counsel must determine whether the confidentiality agreement bars the bidder from approaching existing vendors and/or prospective new vendors. Vendors considering direct investments may be permitted recipients because they are "financing sources." However, counsel must consider whether vendors that might extend "indirect" financing in the form of better vending terms qualify as permitted recipients.

The most prevalent form of vendor financing is in the form of favorable vending terms.

In the authors' experience, if there is any ambiguity in the confidentiality agreement, prospective acquirers are generally better served by reviewing these issues with sellers before approaching vendors. Sellers of businesses may have strong views on timing the disclosure of any sale, and a bidder's willingness to play "fast and loose" may adversely affect acquisition discussions at an early stage in the process.

There are many reasons why a seller may forbid an approach to vendors. The seller may not want to alert people about the transaction and raise concerns with customers and vendors if the sale does not go through. The seller even may be in sensitive pricing discussions with vendors and the talks might come to a halt if the supplier knew the sale would beget another set of similar negotiations.

Legally Binding Obligations and Due Diligence

As described above, if the form of vendor financing is important to the acquirer, counsel should ensure that the terms are reflected in legally binding agreements. Counsel also should assist the acquirer in determining whether it will have practical legal remedies if there is a post-closing breach by a vendor.

For example, legally binding commitments from undercapitalized vendors may not be worth much. Commitments to source products at "too good to be true" advantageous prices from a supplier that ultimately seeks bankruptcy court protection may in fact be too good to be true, because the debtor-vendor may have the ability to "reject" the contract in Chapter 11 proceedings. Finally, the acquirer that recruits a vendor must, as part of the due diligence process, protect the basis on which it is acquiring the business.

In the hypothetical example, the paper pricing charged by Paper Inc. is a function of sales to Good4U, which is its largest consumer of paper products. The buyer should try to lock in that favorable pricing post-closing by getting an up-front agreement with Paper Inc. As an alternative, the acquirer may be able to purchase indirectly through Good4U, although the antitrust implications of such arrangements must be analyzed.

Securities Law Compliance

If a potential acquirer pursues direct investments from vendors, counsel will want to structure the offer and sale so that it is exempt from the Securities and Exchange Commission registration requirements under the Securities Act of 1933 (e.g., a private placement under Section 4(2)). This will permit the acquirer to avoid the extensive time delays and expenses associated with the filing and effectiveness of a registration statement. Under the federal securities laws, the consequences of failing to qualify a direct investment as exempt from SEC registration are:

- Rescission Rights — The vendor may have the right to rescind its purchase, i.e., the vendor may have a put right for an underperforming investment.
- Integration — Failure to qualify for an exemption from registration may adversely affect other contemporaneous offerings. Specifically, if a "bad" private placement is integrated with an otherwise "good" private placement of subordinated debt (e.g., used to finance the acquisition of Good4U's packaging division), all of the sub debt holders would have rescission rights.

Shareholder/Creditor Rights

Direct investments raise a number of capitalization issues that often require the acquirer and its vendor-investor to address issues including:

Ongoing Financials. Vendors that provide credit support usually will require that they be provided with ongoing financial data. An acquirer that does not make its financial data generally available must consider how this will affect its bargaining position with the vendor in future negotiations. For one thing, it makes it harder for the acquirer/customer to plead poverty.

Intercreditor Agreements. Typically, the senior secured bank will require subordinated debt of the issuer to be contractually subordinated to the senior bank position. In effect, the senior bank wishes to view the subordinated debt as its "equity" cushion. However, if the bank expects the vendor's direct investment to be subordinated debt, the senior bank may be very uncomfortable with the prospect that a supplier of "critical" raw materials, not readily obtainable elsewhere, may threaten to withhold deliveries if the senior bank does not make overadvances so the acquirer can keep current on its vendor obligations. Of course, these concerns are a function of the importance of the vendor's products to the acquirer's operations and must be assessed on the basis of the specific relationships involved in each situation.

Specific Rights. Both equity and debt direct investments will require that the acquirer review with its counsel what specific rights typically expected by shareholders (e.g., "exits" such as puts and registration rights, board seats, affiliate transaction bars) and creditors (e.g., amortization schedule, prepayment penalties, negative covenants) are granted to vendors.

Customer Supply Arrangements

An alternative method for closing a purchase price value gap is through use of customer supply arrangements in which the seller commits to buy products from the acquirer. This usually takes the form of a commitment by the seller to purchase some or all of its "requirements" for products from the acquirer. The agreements usually don't cover fixed volumes or "take-or-pay" minimums.

In the authors' experience, transactions in which the customer supply agreements commit the seller to satisfy product requirements through purchases from the acquirer have substantially increased since the early 1990s. Many of these "sale-of-business/product purchase-back" transactions result from decisions by conglomerates to outsource certain manufacturing functions. Former captive suppliers, in turn, have been particularly attractive acquisition opportunities for financial buyers or, in industries where economies of scale are great, strategic buyers manufacturing similar products.

In the hypothetical example, packaging division sales to Good4U represent 40% of last year's sales. Given that Good4U contemplates that its purchases will continue following closing, it is imperative that Mix 'n Match specify the pricing and other terms of this relationship in arriving at its bid price.

The buyer should try to lock in favorable pricing after closing through an up-front agreement.

When the seller of a business is also a significant customer, supply agreements may bridge the value gap. Two principal benefits are obtained when acquirers such as Mix 'n Match utilize customer supply agreements to structure offers:

Direct Financial Support

A customer supply contract containing favorable pricing and/or payment terms often will augment profitability and cash flow and thereby reduce the need for external financing over the life of the agreement. This benefit, of course, is derived over time. For example, if a seller agrees to buy the goods back at a price that will be substantially above market, then it is in effect financing part of the acquisition cost. Obviously, this does not happen very often in the real world. What does happen with some regularity, however, are two other developments that have a direct impact on price.

First, although it is unlikely that sellers will agree to above-market prices at the start, they often are willing to give substantial price protection in divesting supplier businesses. The price protection normally comes in the form of a guaranteed fixed price over at least a three-year period, and sometimes longer. That is a major benefit for a buyer, particularly when the divestiture occurs as part of a program by the seller to become competitive worldwide in its retained business. In those cases, the acquirer must otherwise worry about whether the former owner will try to achieve its lofty goal by exercising price pressures on its suppliers. Price protection is fair game for negotiation, and buyers have been reasonably successful in obtaining levels of comfort in customer supply agreements.

A second factor is negotiation of the days-payable terms after the sale. If the buyer does not get assurances for quick payment terms for 40% of its output, that can have a direct and materially adverse impact on key financial measures, including the working capital financing needed as the business moves forward. A buyer faced with a possible payment stretch-out must ascertain what assumptions about payment terms were reflected in the financial model used to sell the business and insist on no worse.

Indirect Financial Support

Customer supply commitments from the seller may serve as a basis for obtaining third-party financing on better terms. For example, debt secured by the packaging division's assets and cash flow will be viewed as more creditworthy if Good4U's purchase commitments are made as certain as possible. An example would be an agreement that states that all Good4U's can needs, which are expected to be meaningful, must be sourced through the packaging division after the deal closes.

That benefit can be immediate as well as long-term, e.g., lower interest rates, greater borrowing capacity. Depending on the predominance of those formerly captive sales, however, they could be potential impediments to third-party financing. Obviously, if 100% of the acquired division's sales went back to Good4U, then Mix 'n Match should anticipate great difficulty in getting that transaction financed on the strength of the packaging division's earnings power. From a business perspective, however, Mix 'n Match probably does not want that transaction without some commitment for the product from Good4U.

Seller Conflict

It is extremely important for the acquirer to understand the dynamics taking place on the seller side when a conglomerate sells a business and is prepared to offer a customer supply agreement. The deal probably was initiated by people on the seller's corporate development and corporate finance staffs, perhaps with the assistance of their investment bankers. This group's goal is to get the best deal, which means get the best sales price. When they prepare the sales book, the investment bankers will tell them that in a situation like this the seller will get a better deal if it can offer a firm commitment to take the product back. In all likelihood, an outline of the commitment will be in the sales book and the financial model in the book will assume an uninterrupted post-closing revenue stream from sales of product to the seller.

What the acquirer may not see, for reasons having to do with the seller's desire keep the divestiture confidential, is that it is very possible that there has not been much consultation with the divisional operating management. In particular, the key person who may be bypassed is the executive who is responsible for, whose career depends on, and whose bonus is calculated on the margins that the seller is going to be able to earn with its product going forward.

Not surprisingly, this conflict of institutional aims can lead to bitter internal conflict which may erupt right in the middle of the sale process. On one side are the corporate finance people who want the best deal price and who recognize that they must provide a favorable supply agreement. On the other side are the divisional operating people who are going to fight these commitments tooth and nail because, from their perspective, the contract represents a restriction on their freedom to operate and achieve results in the future. Therefore, it is imperative that the acquirer be clear from the outset that its bid is based on specific minimum terms for the supply agreement and that the terms have a direct impact on the deal price. Then, if the acquirer runs into a problem somewhere down the road and needs to readdress the price, it will be in a strong position to demand its version of the customer supply agreement or to reduce the deal price.

The authors have worked on five transactions in the last two years, all with Fortune 500 companies, that involved substantial supply arrangements between the acquirer and the seller. In three of the deals, the price was renegotiated downward before the deal was completed, essentially because there was a disagreement within the seller's organization about how far they were willing to go to commit to a supply agreement.

Legal Issues in Financing Pacts

No matter how important the supply arrangement may be to the deal, it is a commercial reality that contract documentation for commercial supply arrangements tends to be less formal than, for example, acquisition agreements or credit agreements. Although there are sound legal and business reasons for this, it can produce the anomalous (some might say desirable) result that the shortest agreement on the closing table is by far the most important. It is essential that the buyer and its counsel focus their efforts on the key issues involved. These are likely to include the following:

Future Sales

If the supply contract is a contract to provide the seller with all or part of its product requirements, the buyer must be careful not to lull itself into believing that

it guarantees future business under all circumstances. If the customer gets out of the business or sells the business or if technological developments obsolete the supplier's product, the contract may not be worth much. The acquirer may find itself with the firmest requirements contract imaginable and no sales. In our example, the contract involving Good4U to buy cans and cartons may be a firm requirements contract. However, if Good4U in good faith does not have any requirements, e.g., because the new packaging medium of choice is plastic, then Mix 'n Match will lose the benefit of can and paper carton sales post-closing.

Importantly, the acquirer is able to address these problems in the contract. It is one of the areas where an acquirer needs to be more formal rather than less formal, e.g., contracts that obligate a purchaser to either take or pay for a minimum amount of goods. They are referred to as take-or-pay contracts or hell-or-high-water contracts, or, more formally, requirements contracts with minimums.

If intellectual property is a key asset of the divested business, the buyer must insist on appropriate protections.

In the authors' experience, except for a few industries like chemicals, natural resources, and coal, take-or-pay contracts are not the commercial reality. So, if the contract is a requirements contract, it will have to deal with such collateral issues as: What happens if this business gets sold? How can the acquirer assure itself that if the seller later sells itself, the customer supply agreement still applies to the existing customer business? How does the contract deal with technology, product obsolescence, and related matters?

Rights of Set-Off

Terms of the customer supply contract also may be important in obtaining financing. A financing source will expect a provision in the contract under which the purchaser of the goods, e.g., Good4U, agrees that it will not set off claims that it may have against the acquirer against amounts owed under the customer supply contract. That is a fundamental requirement of the financing sources if they are to provide any financing credit for the receivables that are going to be generated from those sales. It is especially true if the financing source is an asset-based lender whose advance rates are based on receivables.

How should the seller react in a situation like that? Assume that to complete the hypothetical transaction Good4U has agreed to take a note back from Mix 'n Match for a portion of the purchase price. If Mix 'n Match asks for a no-set-off provision, Good4U should insist that Mix 'n Match give up any set-off rights it may have under the note for indemnity claims under the acquisition agreement.

Intellectual Property and Non-Compete Issues

Acquirers should be sensitive to intellectual property and non-compete issues in connection with customer supply agreements.

In the hypothetical example, one intellectual property issue involves the cans that are identified with Good4U's products and are protected by a patent. A seller often will claim that a standard term and condition in all of its supply arrangements requires the supplier to make its intellectual property available to the seller/customer at no cost if the supplier defaults. For example, Good4U might maintain that it cannot be left in a position where its can packaging needs are not fulfilled by Mix 'n Match and that, therefore, Good4U must have access to that intellectual property to self-manufacture the cans or have third parties do it.

That issue can be the centerpiece of very tough negotiations. An acquirer such as Mix 'n Match that is paying $250 million to purchase the business suddenly is faced with a situation in which the party that has its $250 million also is claiming rights to regain a valuable piece of intellectual property. That also ties directly into the non-compete issue.

One of Mix 'n Match's key requirements in the acquisition agreement probably is an agreement that Good4U will not go back into the production of cans. Yet, if product delivery defaults occur under the supply agreement, Good4U very well might claim with some justification that it must have the right to ensure its source of supply by any available means, including a return to the direct manufacturing of cans. If intellectual property is a key asset of the divested business, the buyer must insist on protections, no matter how difficult negotiations may be before closing.

Unorthodox techniques such as vendor financing and customer supply agreements can be valuable tools for structuring rewarding deals and providing foundations for post-deal operations of businesses that change hands. In pursuing these techniques, acquirers should understand that they raise a host of business and legal issues that need to be addressed. ■

BEST ORIGINAL AVAILABLE

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VALUATION—AN OZYMANDIAN TASK

Add a dash of perspective to those estimates of breakup values and discounted cash flow.

By MARK FISHBEIN

Value, like beauty, is in the eye of the beholder. When the beholders are many, as in buyers and sellers of stocks, everyone attaches great import to the prevailing opinion. And when the collective opinion about the worth of the 30 companies in the Dow Jones industrial average changes as drastically as it did last October, people who make their living valuing businesses are summarily reminded that their estimates are bound by time and place. Says Jack Levy, a specialist in mergers and acquisitions at Merrill Lynch: "Judgment is key. Valuation is an art, not a science."

The three principal ways of applying this art are estimating the price that buyers would pay for either the entire business or each of its components; developing a valuation based on the market price of comparable companies whose stock is traded publicly; and projecting the future cash flows of the business and discounting them back to a present value.

Most professional appraisers use both the second and third techniques. First they assess a company's worth by comparing it to similar ones trading publicly. They then match that value against an estimate of the company's discounted cash flows. One method accepts the stock-market valuation as valid even though it is subject to sudden and seemingly irrational changes. The other method accepts forecasts of future cash flows even though they are difficult to predict with anything but the greatest uncertainty. "Generally, meaningful projections beyond two years out just aren't posssible," says Gilbert Matthews, head of the valuation group at Bear Stearns.

The courts, which frequently have to rule on valuations these days, tend to place the most credence in those estimates that are derived from stock market data. Says Shannon Pratt, president of Willamette Management Associates, a valuation firm in Portland, Oregon: "In my experience, courts are more interested in provable facts than in projections."

By contrast, finance staffers at corporations tend to emphasize discounted cash flow. "We find discounted cash flow to be a valuable, relatively accurate tool," says Richard Neece, vice president for planning and development at IC Industries. "If investment bankers don't like it, that's because the DCF model is too easy to apply. They have to sell the idea that they bring something to the party, but if you ask some buy side analysts, you'll find that they use DCF too."

Cash flow analysis is particularly well-suited to valuing companies whose future is expected to be significantly different from the recent past, says Roger Orloff, manager of M&A services at Mellon Bank in Pittsburgh. He recently used both the DCF and market-multiple methods to appraise acquisition targets for a client that wanted to acquire a grocery distributor. "When we analyzed the going multiples of trailing 12-month earnings for publicly traded grocery distributors, we missed the fact that the business was near saturation," Orloff says. "Discounted cash flow forced us to look

GLOSSARY

EBIT: "Earnings before interest and taxes" is a measure of the interest burden a company can support given its earnings.

FAIRNESS OPINION: An opinion as to the value of a business being sold. This is often rendered by an independent third party such as an investment bank or a valuation advisory firm. The fairness opinion is supposed to keep the seller's board of directors from accepting an excessively low bid.

FREE CASH FLOW: After-tax income with depreciation and other noncash items (e.g., deferred taxes) added back in, and increases in net working capital (inventories and receivables minus payables) and capital investment subtracted out.

GOING CONCERN VALUE: The value of an ongoing business measured as a multiple of earnings, cash flow, or operating income, as opposed to its liquidation or breakup value.

TRANSACTION MULTIPLE: The purchase price of an acquisition's equity, plus any assumption of long-term debt, divided by operating income. This multiple tells the acquirer exactly what it is paying for the business's ongoing cash flow (before interest and taxes). The multiple can be adjusted for excess cash, contingent liabilities, or undervalued assets.

into the future and recognize that these companies were actually worth about half what their current multiples indicated."

Most analysts agree that the best measure of a business's worth is cash flow, not earnings. Since accounting practices vary dramatically, two otherwise identical companies can report quite different earnings. Says Kit Lokey, president of Houlihan Lokey Howard & Zukin, a Los Angeles valuation firm: "Cash flow is the great equalizer of different accounting methods."

Stock prices track cash flow much more closely than earnings. When earnings and cash flow move in opposite directions, stock prices follow cash flow, says Alfred Rappaport, chairman of the Alcar Group, a valuation firm in Chicago. As evidence, he cites a study by Chaim Sunder, a professor at the University of Minnesota, showing that the prices of 110 stocks increased an average of 5 percent when companies switched from FIFO to LIFO inventory accounting. The change reduces reported earnings but cuts taxes and thus boosts cash flow.

A new measure known as free cash flow has been attracting a lot of attention lately. Free cash flow is the amount that an owner can take out of a business after all the expenditures, such as additions to working capital, that are necessary to keep it going. "Basically, free cash flow is what is left if you subtract cash operating outlays—be they expensed or capitalized—from cash operating receipts," says Joel Stern, chief executive of Stern Stewart, a financial consulting firm in New York. "That's what really determines the value of a business."

One problem with valuing companies by comparing them to similar ones is that the result is based solely on consensus expectations. A stock-market multiple describes how much investors are willing to pay for a given cash flow, earnings stream, or book value in a certain type of company today. But it does not explain why investors are willing to pay that much, and it obviously does not reveal what multiple the market will pay for it in the future.

The only problem with having an investment bank make the valuation is that it has a conflict of interest in rendering the opinion.

Consider what happened to Diamandis Communications in its leveraged buyout of the CBS magazine group. Diamandis and its backer, Prudential Capital, bought the magazine group for $650 million, or 13.7 times cash flow, last fall. It certainly appeared that they had paid top dollar; at the time, other media companies were selling at 11 to 12 times cash flow. But Diamandis managed to sell off some of the publications for $300 million, mostly at multiples above 14. Then this spring it sold the rest of the magazines to Hachette S.A., a French publishing company, for $712 million.

The value of a business to any particular acquirer depends largely on what he plans to do with it. A so-called strategic acquisition is one that fits particularly well for some business reason, such as Wells Fargo's $1.07 billion purchase of Crocker National Bank two years ago. As soon as the deal closed, Wells performed radical surgery on the troubled Crocker by firing 1,600 employees and selling off a quarter of its assets. Six months later, Wells Fargo's stock had jumped 62 percent and the combined operation was doing well.

In today's intensely competitive M&A market, prospective buyers are well advised to stick with acquisitions that offer distinctive benefits. Since no bid goes unnoticed in a market that is as overheated as the current one, buyers have to be willing to pay the highest price for a target. Says Rappaport of The Alcar Group: "The only way for the highest bid not to be excessive is for the buyer to gain a unique synergy from the acquisition."

Distinctive synergies usually are a product of horizontal or vertical integration. Bridgestone's purchase of Firestone Tire & Rubber last February is an example of such unique synergy—namely, a dominant position in the global tire market. The $1.1 billion price "was worth it thanks only to the synergies," says Michael Hoffman, co-director of M&A at Smith Barney. Already a leader in truck tires, Bridgestone will now try to capitalize on Firestone's strength in automobile tires.

While synergies are crucial to success, raiders should never assume that they know how to run a business better than the target management. "Don't be overconfident about how you will run things much better than the previous management," says John Strangfeld, a vice president of Prudential Capital who handled its investment in Diamandis. "Synergies are much more difficult to realize than most acquirers imagine."

Buyers also have to watch out for "reverse" synergies—operating advantages that might vanish with the acquisition. "You cannot assume that a target's best managers will stay on after the acquisition, especially if you do not make them feel welcome," says Pratt of Willamette Management. He adds that it can cost a bundle to keep acquirees happy. Shearson Lehman Hutton is one buyer that has lost the people at companies it has acquired. "Virtually every time they buy a regional brokerage house, a third of its best producers leave within a few months," says Pratt. Shearson's man in charge of corporate affairs, Michael O'Neill, says that the percentage that the firm loses generally is more like a sixth than a third.

Prospective acquirers can buy valuation advice from investment banks or independent appraisal firms like Alcar and Houlihan

Lokey. The big banking firms usually get the business even though their fees are twice as high. A Wall Street firm typically will charge between $250,000 and $1 million to value a $500 million company, depending on the complexity of the business; independent appraisal firms charge $100,000 to $500,000 for the same valuation.

The only problem with having an investment bank make the valuation is that it has a conflict of interest in rendering the opinion. While it is supposed to render a disinterested opinion on the worth of a prospective acquisition, an investment bank often will collect a multimillion-dollar fee if the deal goes through, but nothing more if the buyer walks away.

Clients are supposed to take it on faith that the opinion will be impartial. One solution for those of little faith, says Enrique Anzac, a finance professor at Columbia University, is to have one investment bank do the valuation and another handle the acquisition.

Bankers claim that their valuations are superior to ones made by appraisal firms, despite the potential conflicts, because they are closer to the market. The appraisers counter that investment bankers are not specialists in this particular art, and that they typically spend much less time and effort on valuations.

The little guys maintain that the investment banking firms shoot from the hip and can still charge outrageous fees because clients feel more comfortable with a household name. But regardless of where they go for advice, the most important rule for acquirers is to make sure the eye of the beholder is a cold and calculating one. ■

WHO'S WHO IN VALUATION

MICHAEL HOFFMAN: Managing director, Smith Barney Harris Upham. An enthusiastic advocate of transaction multiple analysis, he claims that acquisition opportunities still exist in the stock market because investors value earnings and dividends while prospective raiders go for cash flow and assets. The prices of companies valued by investors are high by historical standards, but there are still bargains among potential takeover candidates, he says. Hoffman and his group advised Great Northern Nekoosa in its $1.15 billion purchase of Owens-Illinois's forest products group last year.

KIT LOKEY: President, Houlihan Lokey Howard & Zukin. Located in Los Angeles, this large, respected business valuation firm counts the following companies as clients: Borg-Warner, Burlington Industries, Federated Department Stores, and the federal government.

GILBERT MATTHEWS: Managing director and head of the valuation group, Bear Stearns. Matthews claims that no opinion of his has ever been challenged successfully in court. He renders an opinion almost every week. Deals in which he has been involved include Texas Air's acquisition of minority interests in Continental Airlines and US Air's acquisition of Pacific Southwest Airlines (both done in 1987), and the leveraged buyout of AFG Industries this year.

DAVID NICHOLAS: Vice president, American Appraisal Associates. Founded in 1896, the firm has 47 offices in cities around the world and claims to be the nation's largest and oldest appraisal firm. Nicholas and his associates do everything from tax appraisals of family businesses to corporate valuations for clients such as Heublein and Owens-Illinois.

SHANNON PRATT: President, Willamette Management Associates, a valuation advisory firm based in Portland, Oregon. Pratt is the author of *Valuing Small Businesses and Professional Practices* and *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, which were both published by Dow Jones-Irwin.

ALFRED RAPPAPORT: Leonard Spacek professor of accounting, Northwestern University, and chairman, The Alcar Group, a Chicago valuation firm. Rappaport is the author of *Creating Shareholder Value: The New Standard for Business Performance*, published by The Free Press.

JOEL STERN: Chief executive, Stern Stewart & Co. Stern is a zealous advocate of discounted cash flow analysis, and believes that free cash flow is the best measure of value. "He really beats you over the head with it," says one corporate manager. Georgia Pacific, CSX, Home Federal Savings & Loan, Lorimar, Manufacturers Hanover Trust, and Digital Equipment are current clients. ■

Lokey

Nicholas

Pratt

Rappaport

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Chapter 17

Merger Negotiations

James C. Freund
Partner, Skadden, Arps, Slate, Meagher & Flom, New York, New York

When you cut through all the financial and legal hocus-pocus—the accounting treatment, the tax aspects, the corporate and securities considerations—an acquisition is basically a deal between two parties. If they can't agree, the deal doesn't get done. The way they reach agreement is by negotiating.

FRAME OF REFERENCE

Talking about merger negotiations requires a frame of reference—a sense of where you are. Otherwise, it's like blind men feeling parts of an elephant.

There are three principal elements of the framework:

- The characteristics of the deal (including the nature of the companies, the form of purchase price, and the kind of transaction)
- The point you're at in the acquisition chronology
- Whether you're the seller or the purchaser

Seller or Purchaser

Take the last point. It's not just the purchaser wanting to buy cheap and the seller wanting to sell dear. It's two totally different points of view. The seller knows what's being sold, but the buyer isn't quite sure what's being bought. So the buyer's efforts are directed at finding out as much as possible about the seller, both to judge whether the deal makes sense and to create protections in case the seller proves to possess less than meets the eye.

By contrast, the seller is ducking and weaving—walking a thin line between disclosing enough of the bad stuff so that the buyer won't have future recourse, but not so much as to cause the buyer to walk away from the deal.

Characteristics of the Deal

Public or Private Seller. The first significant characteristic of the deal is whether the seller is publicly or privately owned. With a private seller, the purchaser works hard at unearthing the basic facts about the acquired company and seeks two types of contractual protection: the ability to walk away prior to closing if important aspects of the company turn out to be mirages[5] (what lawyers call "conditions"), and the opportunity to be made whole if negative facts turn up after the closing (what lawyers call "indemnification"). With a public seller, the purchaser is buying less of a pig in a poke (since the seller has been subjected to the rigors of public reporting and Securities and Exchange Commission scrutiny), so less digging may be needed. On the other hand, indemnification is usually not available—so the moment of truth arrives at the closing. Obviously, this can affect the negotiating.

Form of Purchase Price. Next is the type of consideration being offered, which bears on what offensive negotiations the seller has to initiate. Cash is the cleanest; all the seller has to worry about is whether it will be there at the closing. If the purchaser is issuing notes or debentures, then the seller has to be concerned with the purchaser's credit down the road. And if the price is paid in the purchaser's common stock, then the seller isn't just selling a company, but also making a significant equity investment in the purchaser, which calls for a lot more knowledge and a judgment on the paper being received. (Today, of course, many deals—particularly those in the public area—involve part cash and part paper.)

Type of Deal. The third characteristic is the type of acquisition. For example, when a private company is being acquired, the issue may be whether the purchaser is acquiring the seller's assets (subject to certain agreed-upon disclosed liabilities) or the seller's stock. In buying stock, the purchaser will be stuck with all the seller's liabilities, known or unknown. This requires the buyer to ferret out the seller's contingent liabilities, tax exposures, and other possible problems, and to negotiate for provisions under which the seller's stockholders will indemnify and hold the buyer harmless from any losses or expenses incurred through contractual misrepresentations. The buyer of assets has fewer concerns along these lines.

If the seller is public, the difference is often between whether the acquisition is done in one piece, as with a merger-type transaction, or in several

steps—combining, for example, block purchases of shares, a tender offer to all shareholders, and a back-end merger. The complexities here can be elegant—particularly when the multistep deal also involves part cash and part stock. Such intricacies obviously have an impact on the negotiating.

Chronology of the Deal

Finally, the point that's been reached in the chronology of the deal can affect many of the strategic and tactical decisions the buyer and seller are called upon to make.

In most acquisitions, there's an initial period of preliminary negotiations prior to any meeting of the minds. If these negotiations are successful, the parties agree in principle on the basic points (such as price); this is often memorialized in a letter of intent. A press release may be issued concurrently. While not a binding contractual obligation, the letter of intent evidences a serious mutual intent to go forward, and—as a brief, straightforward document—is particularly useful in getting a private seller over the hump of parting with the business. This method may be preferable to risking a potential negative reaction by presenting the seller initially with an 80-page "insurance policy" (the acquisition agreement), with him as the "insurer."

The parties then enter into detailed negotiations that cluster around a formal, legally binding acquisition agreement that contains all the terms and conditions of the deal. Typically, most significant acquisition transactions are not closed simultaneously with the signing of the agreement, but rather several weeks or months down the road. The extra time provides for actions that can occur only subsequent to signing or that take time to accomplish, such as soliciting the approval of public stockholders.

So, for purposes of evaluating various issues that may arise, or deciding whether to introduce other issues that haven't yet been on the table, the negotiator must ask what point has been reached in the acquisition process: Have the parties' minds met? Are they legally bound? Is this the best time, from your perspective as buyer or seller, to negotiate particular issues?

For example, as a general rule, it's in the best interests of a seller of substance (who isn't teetering on the verge of bankruptcy and seeking any port in the storm) to negotiate as many significant points as possible before agreement in principle is reached and the transaction announced. In this preliminary stage—when the purchaser is smacking lips over the prospects of bringing the seller into the fold, but the seller hasn't agreed to the price—the seller possesses the maximum leverage to extract real concessions from the purchaser. The seller's edge lies in such areas as the terms of his employment with the purchaser, seats on the buyer's board of directors, registration rights for stock issued in the deal, the terms of any notes to be received, and permitted dividends prior to closing.

Conversely, announcement of the proposed deal usually constitutes a big change in position for a seller. Once suppliers, customers, employees, and competitors know about the acquisition, the seller's business is viewed in quite a different light. If, for any reason, the deal does not go through—no matter what the ostensible reason disclosed to the public—everyone will assume that the purchaser discovered some serious negatives about the seller's business that can have

obvious ill effects on the seller's future prospects. The seller's strong interest in seeing that nothing goes wrong, once the transaction has been announced, weakens the seller's bargaining position in the later rounds. The purchaser, realizing what the seller now has at stake, often takes the tack that the parties should just agree on the price and leave everything else for a later date. ("We'll let the lawyers worry about that other stuff" is a typical remark at this point.)

That, at least, is the conventional wisdom. The fact is that, in this present age of hot competition for desirable acquisition candidates, many purchasers prefer not to announce an agreement in principle without having the seller locked up—the fear being that other bidders will promptly get on the telephone and try to snatch the prize away.

Another issue underscoring the negotiating significance of the time frame is the valuation of the purchaser's stock that will be issued to the seller. The agreement on the purchase price may call for $10 million worth of the purchaser's shares, but what value should be assigned? Presumably, it will relate to the market price of the purchaser's stock, but as of when? Should the value be premised on the time the agreement in principle is reached; or when a binding agreement is signed; or at the closing, when the seller actually gets the shares; or on an average price over a specified period? This can be important, because prices can change dramatically over the course of a long-winded acquisition transaction. This same negotiating issue also can arise in the much more complex context of a part-cash, part-stock, tender offer/merger combined transaction, involving such esoteric items as "collars" (placing limits on the number of shares issuable should the stock price change dramatically in the course of a deal) and "cramdowns" (requiring someone who opts for cash to take stock, or vice versa, in order to ensure the required relative percentage selection of cash and stock).

NEGOTIATING THE PURCHASE PRICE

Let's talk about purchase price. As a lawyer, I'd never presume to advise a buyer how much to pay for an acquisition or counsel a seller on how much to accept for a company. But if I know what they really have in mind—which isn't always the case, because many clients (in effect) negotiate with their lawyers—I can offer some helpful advice on how to get there. Here are my personal 10 guidelines in this area:

So Long, Buddy. At the point in the deal when you're negotiating price, neither party is committed. So, if you take an unreasonable position—which might have some appeal under the rubric of playing hardball—you have to realize that the negotiators on the other side may just get up and walk away. It's not like a labor negotiation, for instance, where the two sides ultimately have to do business. Nor is it like settling litigation, where you're paying a price to remove uncertainty. There's usually somebody else waiting in the wings to buy the seller, and another target of opportunity for the buyer.

Don't Win Big. Moreover, I've always felt that, at least from a psychological point of view, if you *really* win, you lose. For example, a purchaser offers $6

million; the seller asks $10 million; the purchaser sticks at $6 million. The seller says "it's a deal." Now, the purchaser whirls around to his advisers and cries: "Hey, wait a minute—what's going on here? What does this seller know about his business that I don't know?" That purchaser would be much happier paying something more than $6 million and feeling that some hard-fought negotiations had been endured. Tight is better.

Don't Let It All Hang Out. In this day and age, it's simply foolish to start out with your best offer as a purchaser, or express your minimum acceptable price as a seller—even if you label it as such, and ooze sincerity. The other side just won't believe you. In addition, they want to have the satisfaction of seeing you move in their direction.

No Unilateral Bidding. Try not to get in the position of bidding against yourself. For example, a purchaser offers $6 million; the seller says, "That's way too low; I won't even consider it; you'll have to do better." The purchaser bids $6.5 million. Not wise. Why go up in price without knowing what the seller is looking for? The buyer is better off holding fire and trying to persuade the seller to name a price. An exception is where you have reason to believe that the seller will put forth an absurdly high price—much above the actual goal—and thereby dig a hole from which it will be difficult to escape. You should use other means to ascertain the seller's level of interest and keep the bidding unilateral for the moment.

A Pox on Small Gradations. If the bid is $6 million and the asking price is $10 million, and the buyer inches up to $6.1 million, $6.15 million, and so forth, it's possible a deal may be reached in a few years. But in the real world, the likelihood that negotiations will be aborted along the way is just too great. Also, constant changing of the price proposal—even with small changes—encourages the other side to wait for next week's version; there's no credibility, no finality, to any particular offer. I recommend a limited number of bolder moves.

The Real Key. Stated affirmatively, the most important ingredient for successful acquisition negotiations is taking responsible positions and making meaningful concessions at appropriate junctures.

Here's Why. Always develop and express to the other side a rationale for your initial price proposal and any subsequent moves. It helps, of course, if the rationale makes good sense. But even if it doesn't make sense—even if it's something as subjective as a seller saying, "I just want to walk away from this deal netting $5 million for myself after taxes; that's been my long-term personal goal"—the other side has to give it some credibility. A reasoned approach puts some backbone into your position. By contrast, numbers that appear to have been plucked out of the air carry little weight in your adversary's assessment.

Stick for a Day. If you come into a meeting and offer a price, together with good rationale to back it up, then no matter what cries of inadequacy it provokes from the other side, you shouldn't retreat from it at that session. If you do, it will

undermine the force of your proposal. By all means, keep talking. Find out as much as you can about the other party's needs, discuss other issues, even suggest (if necessary) that you ultimately might have some price flexibility. But don't waffle that day.

No Bluffs. Never state definitively that a certain price is as far as you're willing to go if that's not your actual walkaway price. You run too great a risk that the other side will either believe you, find the price unacceptable, and terminate the negotiations; or will not believe you, call your bluff, and place you in the embarrassing position of having to back down. There are other ways to get across the relative solidity of your position without getting yourself in this uncomfortable position.

Slow Down on Splitting. When the bidding starts to get close—let's say the range has been narrowed to $7.6 million and $8 million—don't rush prematurely into the middle, offering to split the difference. Assume the purchaser does offer to split at $7.8 million. That becomes the purchaser's new position, while the seller is still at $8 million. The deal probably will end up closer to $7.9 million. There are more subtle means of ensuring that both sides move toward the midpoint.

ISSUES BEYOND PRICE

Once beyond price, most of the issues to be negotiated involve the acquisition agreement. The representations and warranties, the covenants, the conditions to closing, and the indemnification provisions generate quite a bit of heat (and not just among lawyers, although they tend to lead the charge). Pitched battles are fought over such seemingly innocuous concepts as materiality and such reasonable-sounding phrases as "to the best of seller's knowledge."

I suggest the negotiators keep these important ABCs in mind:

A—for gaining Advantages, where appropriate;
B—for never forgetting there are Businessmen involved; and
C—for solving problems and achieving Compromises.

The key for any negotiator is achieving a functional balance between getting a leg up on the adversary and working out satisfactory compromises, while not losing sight of the human elements involved. You win some, you lose some (not the really crucial ones, however), you compromise some, and, above all, you keep communicating.

Gaining Advantages

Let's start out on the offensive. After all, there are gamelike aspects to the acquisition business, and attaining your goals not only makes good business sense but induces a heady sense of satisfaction.

The biggest advantage in negotiating most agreements, including those in an acquisition, is drafting the document. The other side can kick and scream over the contents, but in my experience, it never gets all the way back to an even-

handed contract. Typically, drafting the document is the purchaser's prerogative, which definitely should be asserted; but if you're a seller, at least you can volunteer to draft those portions inserted into the agreement at your insistence. But remember, the most egregious provisions rarely go unnoticed. They're inevitably contravened, which leads to hard negotiations and often unsatisfactory compromises. The real value lies in subtlety—the ability to inflict legal results on your adversaries without their knowing they've been had.

You need persistence to prevail in this trade. Never show up for an out-of-town bargaining session with your suitcases packed, having checked out of the hotel. Instead, convey the impression that you have all the time in the world to hold fast on basic points. But remember, you also need perspective. You must know when to press and when to yield—and you can't hang tough on all the little issues.

Labeling your position on each issue as nonnegotiable is not calculated to make a deal; and banging your fist on the table, whether out of frustration or to show toughness, is out of place in these sorts of transactions. But remember, there are times when it's important to take a stand on a real deal breaker (not a sideshow). Sometimes a momentary flare-up of emotion is needed—for example, when your adversary tries to retract what has already been conceded—as a warning of a dangerous road ahead.

The gut issue is whether to give up points that you can afford to cede, or hold them back as trading bait for other matters that may arise later. This is part of the broader issue of timing, which comes up at so many points in the acquisition context. If there's little ostensible justification for your position, it's probably better to yield on the spot, because you'll undoubtedly need your adversary's cooperation on different issues later on. If your position has merit, the key aspect to weigh is what's still ahead. If you suspect there's much yet to come, there's probably no rush to reach an accommodation.

When you have negotiated more than one acquisition, you'll find yourself picking up some of the tricks of the trade. One is to use a really absurd example to illustrate the crazy result your adversary's overbroad draftmanship could produce. Another is to listen carefully to what your adversary says in one context, and then throw these words back in another. Don't be ashamed to indulge in such tactics. They work, and you need all the help you can get.

The Businessmen

It's easy to lose sight of the people involved in one of these deals, but a good negotiator never does. I've seen acquisitions negotiated over a period of several months, to the point where all problems appear to have been solved and both sides are on the verge of signing an agreement. Suddenly, the seller walks away. The seller hasn't been properly stroked, or fears unwelcome changes will occur as part of the purchaser's corporate bureaucracy.

When negotiating, make sure to determine who the real decision maker is on the other side. It may not be the person who's doing all the talking. But the decision maker is the one to make your pitch to—and if that person is not in the room, then save your breath. Above all, don't get caught in a situation where you are authorized to make concessions, but the person sitting on the other side of the table lacks the same discretion.

I find that I need to spend more time in an acquisition discussing matters—negotiating, if you will—with my clients than with the adversaries. Energizing a corporate team to move in a constructive direction is not an easy task for businessmen or lawyers because there are lots of bases to touch. Those furthest from the negotiations tend to take the toughest line. And whoever plays the role of the moving force (since most movement is toward the center) has to risk being perceived as "giving away the store." But I'm convinced that this is the only way deals get done, and you must allow time for the process.

A word about lawyers. Many businessmen subscribe to the view that lawyers not only don't make deals, they break them. Much of this attitude stems from the timing of the situation. Often, after the parties' minds have met on the subject of price, the lawyers are called in and they proceed to ask hard questions on which the negotiators have neglected to focus. These questions involve such touchy matters as escrows and noncompetition covenants. As disagreements inevitably surface, the attorneys shape up as the handiest scapegoats. Nevertheless, there is some truth to the observation, because many lawyers—trained to view propositions with a cynical eye, searching for what could go wrong, ferreting out the problems ignored by others—have a tendency to overdo this negativism, often at the expense of the deal. You should be able to distinguish between a lawyer who acts constructively, pointing out a problem and suggesting possible alternative solutions, and one who simply nitpicks. It takes large doses of flexibility and improvisation to see an acquisition through to fruition, and you ought to feel comfortable that your lawyer is working effectively toward achieving your goals.

Compromise

I start with the proposition that almost all situations of seeming impasse are ultimately soluble. It may, however, take a little imagination. So many issues that masquerade under other colors really just involve money. By moving that commodity around a little—sometimes dressed up in acceptable costumes to save face—buyer and seller can work most things out.

It often takes some real creativity to discover the common ground on which both sides can agree. They have to distinguish between the positions that each is taking, and their respective real interests, which may be considerably narrower. The key often lies in splitting into segments what had appeared to be an indivisible issue.

Finally, as you get down to the short strokes at the end of a deal, little issues tend to become magnified out of all proportion to their actual importance. Try to put things in perspective. Keep cool, keep communicating, and keep your eye on the ball, which—when it gets down to the wire—is getting the deal done.

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WHARTON REPROGRAPHICS

7 Corporate Development Alternatives

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Mergers and acquisitions are but one weapon in a company's corporate development arsenal. The choices for executing business projects for generating value-creating growth are varied. It is likely that the well-managed firm will use all or most, depending on which format emerges from an analytical work-up as the most potent for a specific program.

In popular parlance, the options fall under the rubric of the "buy-versus-build" decisions. But that often overworked term touches only the extremes of the range—"buy" as the synonym for obtaining the resources needed to put a project across through acquisition, "build" as the emblem for doing all of the work in-house or through *de novo* expansion. Thus, the buzzword overlooks the myriad choices between the two flanks, such as:

- Joint ventures
- Strategic alliances
- Minority investments
- Venture capital
- Licensing
- Technology sharing

- Marketing and distribution agreements
- Franchising

Each choice has generic advantages and drawbacks, the proverbial trade-offs, and the pluses and minuses often become more complex and finite when applied to a specific business project. Key components of the checklist obviously are economic and financial—wringing the most out of the least investment in the fastest possible time. But tradition, culture, technological prowess, management competency, customer-supplier relationships, and other qualitative factors often figure strongly in the balancing act required to tap the best strategy.

THE BUY-VERSUS-BUILD DECISION

Although the corporate development commanders can push any number of buttons, their decisions often boil down to selecting "buy" or "build."

Acquisitions can be compelling because they are short-cuts to getting what is needed, but they are not for everybody; nor are they appropriate for every project or program launched by a business. Indeed, many highly successful firms eschew acquisitions entirely or rarely do them. Minnesota Mining & Manufacturing, with its diverse array of consumer and industrial products, Merck & Co. in pharmaceuticals, Texas Instruments in semiconductors, and Johnson & Johnson with its multiple lines of health care products are examples of companies that have bet successfully on internal development to sustain strong track records.

Nevertheless, even many of the most internally oriented firms usually don't overlook the potential of mergers and acquisitions in their screening processes. Acquisitions can add new products and technologies, widen customer bases, harvest critical skills, plant the company's flag in new geographic markets, and expand production capacity with almost lightninglike speed. Absorption of entire organizations can give the acquirer a leg up on competitors while generating immediate contributions (financial, technical, etc.) to the combined company. While purchases may involve large up-front outlays, acquisitions can be more cost-effective than the *de novo* route. Paybacks are faster and the learning curve for start-ups can be eliminated.

But these advantages disappear for many companies, especially deep-pocketed firms geared to heavy investment in R&D, new product development, and capital spending to enhance productivity—those typically on the cutting edge of technology, or those with such huge market shares that acquisition would be an overkill. External opportunities dry up because there seldom are businesses, people, plants, or processes outside the firm that are worth acquiring, or that even exist. These firms are far better off developing technologies, launching new products, or moving into new geographic territories on their own.

Yet, even when the choice is not so clear-cut, many companies prefer to do it themselves. For some, internal development is so embedded within their strategic game plans that they have learned to live with and manage the delayed paybacks

and learning curves while producing very respectable returns. Frequently, these companies have developed unique skills in building new plants, shaking out new products, invading new territories, and recruiting critical personnel to cushion them from the most severe problems inherent in start-up projects. In a *de novo*-based strategic scenario, the acquisition may be viewed as a device for spreading the investment capital pool too thin.

But there are many other reasons for passing up acquisitions. Some companies simply have no stomach for buying. They may dislike shelling out large one-shot payments and favor staggering their outlays in smaller bites over the term of a start-up. The prospect of competing for target companies in the M&A market repels many managements, a large number of whom also are turned off by having to negotiate with people in another organization. And a number of companies admit they lack the skill or the will to integrate another business and its personnel into their organizations.

Timing also is important. When the M&A market is hotly competitive, many companies, including active acquirers, reject the high prices they might have to pay as uneconomical investments, and opt for internal development to achieve the same goals.

JOINT VENTURES (JV)

Corporate partnering has become increasingly fashionable in the 1980s and the 1990s. The most common form is the joint venture in which two or more firms join forces to create a new jointly owned business entity for a specific purpose. JV formations have been driven by financial, market, technological, and geographic forces, but, despite potentially great economic advantages, they are fraught with problems that invariably are cultural in nature. Indeed, many ventures don't pan out because of governance conflicts or culture clashes between the partners.

Generically, the joint venture format allows businesses to pool various types of resources for common gain. A major drawback from the start is that neither firm will get 100 percent of the rewards pie. Even though each partner might be better off than if it had not entered the alliance, the very idea of having to share the wealth rankles some businesses. This issue has to be addressed at the time the JV agreement is reached, or it can become an insurmountable hurdle to success.

The JV can be crafted at several strategic levels. A common type of venture is in essence a start-up business devised to develop a new technology, to commercialize products from newly developed technologies, or to set up in new markets. Each of the partners brings skills, knowledge, and resources to the venture that they would have had to acquire and develop had they chosen to go it alone. In addition, a joint project may be desirable to spread the escalating costs of technological advancement or acquiring complementary resources. IBM, Texas Instruments, Apple Computer, Du Pont Co., and Corning, Inc. are among the technology-centered companies that have formed alliances with both technology and nontechnology firms to push strategic development. Corning, for example, derives about half of its sales and earnings from technology-type joint ventures that leverage its skills in the glass and ceramic fields.

Another type of joint venture, sometimes referred to as a "near merger," combines existing subsidiary businesses of two or more companies. The aim is enhanced market clout. These types of partnerships frequently are forged in mature markets where the partners have relatively small shares but want to hang in as part owners of a larger enterprise. B.F. Goodrich and Uniroyal combined their tire businesses in efforts to create a stronger competitor to industry-leader Goodyear Tire & Rubber.

However, secondary players in growth markets have used the same tack. General Mills and Nestle joined forces to push worldwide expansion of their cereals businesses. General Mills also entered a JV with the Frito-Lay business of PepsiCo, Inc. to create a formidable player in the European snack food market. Eastman Kodak put its Sterling Drug subsidiary into a JV with Sanofi of France to create the research and marketing mass needed to compete in the globalizing and increasingly expensive pharmaceutical business. And Merck & Co. and Johnson & Johnson got together in a venture on over-the-counter pharmaceuticals, linking Merck's research prowess with J&J's marketing skills.

The JV log contains numerous cross-border combinations; that is, between companies situated in different countries. In entering a new country, a foreign firm frequently will take on a local partner that knows the territory and often is willing to chip in financially. The Toys "R" Us chain in Japan is a JV between Toys "R" Us of the United States, supplying the retailing skills and concepts, and McDonald's Japan, with its expertise in acquiring store sites in that land-scarce country.

There are numerous variations on the basic themes. JVs may be substitutes for acquisitions. When Philips NV of The Netherlands wanted to move its test and measurement instruments into the United States, it set up a reciprocal distribution venture with John Fluke Manufacturing, an American firm that makes similar products. Markets are widened for both firms as Fluke distributes the Philips lines through its established distribution system in the United States while Philips distributes Fluke products in Europe.

In a variation that combines elements of acquisitions and venturing, a JV can be created when a company sells part interest in a subsidiary to another business. Philips sold the Whirlpool Corp. of the United States a major stake in its home appliance business, which provided the American firm with entry into overseas markets. In some cases these deals may be preparatory to complete acquisition by the "investor," which is what happened when Whirlpool eventually bought out Philips's remaining interest.

There also has been considerable activity involving an operating company's sale of a part interest in a subsidiary to an LBO sponsor. Deals of this type often have occurred when the company regards its unit as being essentially in a different business, but cannot withdraw entirely from the scene. For example, manufacturing companies have sold partial interests in distribution subsidiaries to LBO investors, removed those assets from their books, and turned management over to the financial partner. The original parent decided that it must keep a hand in the distribution unit in order to keep its supply and distribution chain intact.

Finally, there is the joint venture acquisition in which two or more companies team up to buy an operating business, either to spread the cost or to carve up the jointly owned businesses at some future time and distribute specific assets to the

partners that covet them most. When Loral Corp., the defense supplier, bought the Ford Aerospace unit of Ford Motor Co., it took in Lehman Brothers as a partner to help pay the purchase price of more than $1 billion.

A major trick in operating a JV is to ensure that the partners continue to like each other after the honeymoon, or at least as long as the perceived economic advantages can be realized. Obviously, many JVs collapse because the economics or technologies won't work. Indeed, many start-up type JVs are as big a gamble as speculative internal developments or acquisitions, and their casualty rate is high. But all too often, people clashes don't allow the venture even to reach that moment of truth.

As a result, it is imperative for joint venture partners to go beyond the numbers and the promises, and conduct due diligence probes as intensive as for any acquisition. Cultural hot spots must be identified and the partners must draft agreements—including mechanisms for exiting the investments on amicable terms—that deal with potential clashes. Up-front meetings of the minds on strategies, investment timetables, sharing of rewards, and the contribution of financial and other resources, as well as the proportionate distribution of ownership mirroring the contributions, are vital in preventing future sticking points.

While a sure-fire cure for cultural eruptions doesn't exist, experienced venturers say structure and governance systems are important. Ideally, the venture must be set up as an independent business, especially when there is 50-50 ownership, with the power and flexibility to make as many of its own decisions as possible without getting clearance from the parents. Personnel assigned to the venture should cut most of their ties with their old employers, even to the point of creating separate compensation and pension plans. A brand-new culture is desirable. The allocation of seats on the board and the board's powers should be spelled out.

Accounting, tax, financial, and legal issues also are prominent in JV formations. For example, owners of a 50-50 JV will use the equity method of accounting in plugging the venture's results into their own books, as will a partner with a minority interest. If one partner owns a majority, it can consolidate the JV's financials in its own. The JV may be structured as a corporation or a partnership, and the implications of each format must be studied before a choice is made.

STRATEGIC ALLIANCES

Except for the fact that they involve at least two companies, strategic alliances defy an exact definition. That is because they come in many formats and utilize many different approaches. However, it is generally agreed that a strategic alliance spreads an umbrella for longstanding business relationships between the allies. Under that rubric, the alliance may in fact lead to joint ventures on specific projects, technology sharing, marketing agreements, and other developmental approaches.

However, one feature that has been common to most arrangements is cross-shareholdings between the partners. Beverage producers Allied-Lyons of the United Kingdom and Suntory, Ltd., of Japan formed an alliance in which each bought small interests in the other and set the stage for a wide variety of allied projects such as distribution in each other's prime marketing territories. The strate-

gic alliance between Renault of France and Volvo of Sweden included the purchase of interests in each other's truck units. And as illustrated by those examples, the strategic alliance invariably is a cross-border arrangement driven by the relentless globalization of key industries.

Since strategic alliances are relatively new and many of those formed are still being developed, their efficacy cannot yet be determined. However, the joint venture principles of establishing common goals and values and ameliorating culture clashes—especially critical in cross-border settings—are important.

MINORITY INVESTMENTS

Several large companies, especially in technology- or research-intensive fields, maintain active programs for taking minority positions in smaller businesses. Typically, the investee company is a smallish firm, public or private, that is working on a leading edge technology or product but needs a cash infusion to move forward. The big company provides the funds in return for positions on the board and other rewards.

The intent of the investment seldom is to eventually acquire the investee. Rather, many minority investments take on features of strategic alliances in which the investor company is interested mostly in manufacturing or marketing rights to the products or processes being developed. Why not acquire? The price of the investment usually is much cheaper, which mitigates risk, and if the investee is in a developmental stage, it is difficult to value. But perhaps most important, companies with active minority investment programs say they want the investee to maintain an entrepreneurial flavor that could be stifled if the small firm were incorporated within corporate bureaucracies.

As with all other corporate development initiatives, minority investments require considerable study before commitments are made.

Many investees remain stand-alone companies, and some have gone public with large returns for the investors. Eastman Kodak, IBM, Pfizer, Inc., AT&T, and SmithKline Beecham are among the companies with wide-ranging minority investment activities.

The minority investor also can be a "white squire" that insulates the investee company from being taken over unwillingly. For example, the voting power of AT&T's investment in Sun Microsystems expands sharply if Sun is attacked by a hostile suitor.

VENTURE CAPITAL

Venture capital investing by large companies is a first cousin to minority investments. The major difference is that investees are more like prototypical venture-capital-backed start-ups that have high promise but no track records. Easing the risk through relatively small commitments and the desire to let investees operate as entrepreneurial businesses also drive venture-capital investments.

The company with a venture-capital program typically sets it up as a separate unit staffed by experienced venture capitalists familiar with the risks and rewards and the analytical skills required to reach a decision.

Lubrizol Co., W.R. Grace, and the privately owned Hillman Co. are among the companies with venture-capital programs.

LICENSING

Licensing is a versatile corporate development device for adding value to an asset or increasing cash flow streams.

Licensing techniques are prominent in technology industries such as electronics, computers and computer peripherals, and pharmaceuticals. A company may license another business to use a patent or a proprietary product or process and receive royalties from the licensee. The technique can speed the payback from an expensive development and widen distribution in far-off markets with little or no investment. But the quid pro quo is that the licensing firm must surrender a part of the returns. Licensing also allows the developing firm to establish an especially strong process or technology breakthrough as the standard for its industry, thereby enhancing its position in its primary markets.

Licensing can also be used for names and trademarks. Rights to names can be licensed to firms in foreign countries; or they can be granted to firms outside the licensing firm's core business. Apparel manufacturers, for example, frequently license their brand names for clothing items they do not produce.

MARKETING AGREEMENTS

Companies reaching marketing agreements with other firms usually are trying to widen the distribution of their products at the lowest cost. In some cases, however, one of the parties to the agreement lacks marketing skills or a distribution network, and is joining with a firm that can do a better selling job. Additionally, marketing agreements may call for reciprocal distribution in which the partners have experience in different core markets. Marketing agreements often are made between companies based in different countries.

TECHNOLOGY SHARING

The escalating cost of developing technology has driven many research-intensive companies to share their know-how and their developments. For openers, the agreement usually covers a pooling of knowledge or joint efforts on a specific project. Marketing agreements, licenses, and royalties may follow.

FRANCHISING

Operating companies historically have suffered harsh experiences in franchising their names or operations. That is usually because franchising is a specific business involving a special mind-set and expertise in real estate, marketing, services, and often-fractious franchisee relations which most operating companies lack. Corporate development professionals seldom recommend franchising unless the company sets it up as a self-contained business staffed by franchising professionals, or farms the program out to a franchising specialty firm under very strict guidelines.

WHICH WAY TO GO

The choices are varied and none is perfect. But the options offer a business a menu of options that can be culled to determine which is best for reaching the perennial goal of generating value-creating growth. Since each is replete with numerous trade-offs, solid analysis is necessary to map out the optimal path.

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WHARTON REPROGRAPHICS

23 Leveraged and Management Buy-outs

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The objective of a leveraged acquisition is to combine a capital structure that incorporates a disproportionate amount of debt with a substantial and predictable cash flow, to provide higher than normal returns to investors. This chapter will discuss how this can be accomplished by describing the assumptions inherent in a leveraged transaction and by analyzing the companies that seem to best fit the model. It also will cover the nature and composition of the investor groups in leveraged buyouts and the form of governance and controls they employ.

STRUCTURE OF THE LBO

Because leveraged acquisitions increase financial risk by allocating a large portion of corporate cash flow to interest and principal payments that are fixed by contract, the creditors and investors demand higher returns than they would from a business that has similar operating characteristics but is capitalized substantially with equity. These higher returns result from changing the financial risk of the business by adding debt in place of equity. How much the equity can be levered is determined by

Table 23.1. Widget Corp. of America (in thousands of dollars)

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	$50,000	$53,000	$56,180	$59,550	$63,124
Operating Income	5,000	5,300	5,618	5,955	6,312
Taxes	2,000	2,120	2,247	2,382	2,504
Net Income	3,000	3,180	3,371	3,573	3,788
Depreciation	450	477	506	536	568
Investment	450	477	506	536	568
Net Cash Flow	3,000	3,180	3,371	3,573	3,788

matching the cash flows from a five-year operating plan to a capital structure that is divided into several layers of risk. That risk is based on the company's expected generation of cash after its own capital spending commitments and the availability of its assets to collateralize loans.

To understand how this works, it helps to look at a hypothetical case. Assume that Widget Corp. of America has had a sound history of profits with modest growth. Widget's product is well-positioned in its markets and has little risk of technological obsolescence. Widget invests continually in improving its product and in customer service, but is able to generate more cash each year than is needed to maintain market leadership. Widget has no debt. Expectations for revenues and operating income for the current fiscal year and for the next four fiscal years are in Table 23.1.

Widget has experienced relatively little cyclicality and needs to invest only about 15 percent of its free cash flow to keep up with its business growth. (To keep things simple, depreciation is assumed to match investment.) With so predictable a business, Widget has a straightforward and debt-free balance sheet, as shown in Table 23.2.

Widget Corp. is an attractive business. It turns its inventory eight times, collects its receivables in 45 days, and doesn't require much new investment. It is growing and will earn about 16.2 percent on its equity.

However, it's 82-year-old owner has decided to sell the business to put his affairs in order. The very capable, in-place management team would like to buy it. Accordingly, they open discussions with lenders and investment groups, and they learn that Widget is worth $25 million to $35 million in the acquisition market. Based on the company's assets and cash flow, a bank would be willing to lend $12 million to $16

Table 23.2. Widget Corp. of America Statement of Financial Condition

Assets ($ thousands)		Liabilities ($ thousands)	
Cash	$ 1,000	Accounts Payable	$ 5,000
Accounts Receivable	6,250	Other current liabilities	1,000
Inventory	6,250		
Current Assets	13,500	Current liabilities	6,000
Property, Plant & Equipment (gross)	5,000	Long-term debt	0
		Stockholders Equity	12,500
Total Assets	18,500	Total liabilities and stockholders equity	18,500

million to a new company organized to do a leveraged buy-out. The bank will require investors to commit $6 million to $8 million in equity to the transaction. Professional equity investors who are able to provide this capital will require annual internal rates of return of 25 to 35 percent, roughly twice what the company earns on its present equity. To make these high equity returns possible and to fill out the missing $8 million to $12 million, an institutional investor willing to buy a subordinated note must be found. The noteholder will require both a high rate of interest and an equity participation, either purchased directly or in the form of a warrant, for taking this risk.

To analyze whether it is possible to meet the needs of these parties, return to Widget's forecast of income and cash flow and assume that:

- The seller will accept $29 million and that $1 million in fees and expenses will be incurred in completing the transaction (for an aggregate purchase price of six times operating cash flow)
- The senior lender will require an adjustable rate of 1.5 percent over its base rate
- The subordinated noteholder will require an interest rate of 13 percent

Given these assumptions, which approximate the market for these accommodations, Widget might have a postacquisition capital structure that looks like this:

Senior debt	$16,000,000
Subordinated debt	8,000,000
Equity	6,000,000
Total	$30,000,000

Assume that the senior debt, with an interest rate of 8 percent throughout the term of the loan (generally five to seven years in LBO transactions) can be retired by the available cash flow. Also assume that the subordinated debt is retired only after the senior lender is paid in full. Under those conditions, Widget Corp.'s income statement and cash flow in a leveraged environment would be changed as shown in Table 23.3.

Its opening balance sheet would be as reflected in Table 23.4.

Before an explanation of the consequences of the proposed transaction, let's look at what happens to Widget as a result of the acquisition.

Table 23.3. Widget Corp. of America Projected Statements of Income and Cash Flow (in thousands of dollars)

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	$50,000	$53,000	$56,180	$59,550	$63,124
Operating Income	4,640	4,919	5,214	5,526	5,858
Interest	2,320	2,179	2,017	1,832	1,620
Taxes	928	1,091	1,278	1,477	1,695
Depreciation	810	858	910	965	1,022
Investment	450	477	506	536	568
Net Cash Flow	1,752	2,025	2,323	2,646	2,997
Remaining Debt	22,248	20,223	17,900	15,254	12,257

Table 23.4. Widget Corp. of America Statement of Financial Condition

Assets ($ thousands)		Liabilities ($ thousands)	
Cash	$ 1,000	Accounts payable	$ 5,000
Accounts receivable	6,250	Other current liabilities	1,000
Inventory	6,250		
Current assets	13,500	Current liabilities	6,000
Property, plant equipment	9,000	Long-term debt	24,000
Goodwill	13,500	Stockholders' equity	6,000
Total assets	$36,000	Total liabilities and stockholders' equity	$36,000

The purchase price of $30 million is $17.5 million more than Widget's net asset value before the acquisition. The allocation of this excess is an important part of any acquisition, and there will be differences in the treatment of certain assets for taxes and for book accounting purposes. In most acquisitions some of the purchase price can be allocated to receivables and inventory, and accelerated depreciation can be used for tax purposes. These adjustments often result in a first-year tax loss.

For our purposes, Widget has allocated $4 million of the purchase price to fixed assets, depreciating them as before, and the balance to goodwill. A more aggressive allocation, which would likely be permitted, would result in cash savings from taxes that were not incurred; this money would be applied to debt payment, thereby enhancing the ending equity value.

The capital structure for Widget would be driven to a considerable degree by a senior lender. It would examine Widget's assets and determine its interest in providing a revolving credit, advancing its customary 80 percent against receivables ($5 million) and 50 percent against inventory ($3,175,000). In addition, the bank would be asked to provide a $9 million term loan based upon both the available fixed assets and the company's unusually stable cash flow.

In our model, Widget never uses more than $16 million of these credit facilities; but by structuring the loans this way, the organizers provide the company with some excess credit for working capital. The bank is being asked to stretch its normal standards to extend this much credit, since the assets do not fully cover its loan. If the lender agrees, it will do so based on Widget's strong cash flow, its ability to retire the entire facility in slightly more than six years, and the general strength and predictability of Widget's business.

It also is important to the senior lender that the management be willing to invest its own cash in Widget's equity (assumed in this case as 10 percent of the dollars) and that a respected private equity firm agree to organize the transaction, commit to investing the required balance of $5.4 million, and arrange any additional financing. The subordinated noteholder would base its decision on many of the same considerations. The organizers will need to provide it with a total annual internal rate of return on its investment of approximately 20 percent, assuming that Widget is resold after the fifth year at the same multiple of cash flow.

The basic pieces of this structure can be said to apply fairly consistently to leveraged acquisitions, whether the amount of financing required for the acquisition is $30 million, $300 million, or $3 billion. The proportions, however, have varied somewhat during the modern LBO period (roughly 1975 to the present) depend-

ing on economic conditions, acquisition and stock market valuations, and the availability of credit. For instance, when inflation was high, stock prices were depressed and credit was accessed inefficiently, transactions such as WesRay's famous 1982 acquisition of Gibson Greetings were accomplished with little equity. In the later 1980s, when equity and acquisition values were full, inflation was moderate, credit was readily available, and the high-yield bond market was open for newly issued debt of freshly minted LBOs, 10 percent of the purchase price was all that was required of deal sponsors. That often was because it was believed that values available in the then highly liquid acquisition marketplace made the operating components of any given company worth more than the whole. In the no-nonsense 1990s, with very low inflation, high common equity values, low acquisition values, and illiquid credit markets, sponsors must contribute as much as one-third of the purchase price in equity. These changes in proportions, of course, affect the returns and risks of the various parties in predictable ways.

In the case of Widget, the organizer has arranged the acquisition with a 20 percent equity component. If management receives an additional 5 percent in stock for free (for a total ownership of 15 percent) and the subordinated debt holders receive a warrant for 20 percent of the company, each of the investors earns its targeted returns if Widget performs according to plan and is sold again in year five at six times earnings before interest and taxes (EBIT).

CHARACTERISTICS OF A SUCCESSFUL LBO

As the description of Widget Corp. of America suggests, words like stability and predictability apply to leveraged acquisitions. To be a financial success, a leveraged buyout must accomplish several very straightforward objectives. It must retire its debt on time and, hopefully, faster than the agreed schedule. It also must reward the equity investors who took the financial risk with commensurate returns. Annual internal rates of return of 25 to 35 percent over an assumed five-year holding period have been considered appropriate.

While meeting the needs of its investors in both debt and equity, the business also must invest in itself to prolong or improve the value of its products to its customers. Therefore, it must have generated sufficient cash over and above its debt obligations to invest in retaining or enhancing its competitive position. If this is not done, the company will not command an attractive price in the acquisition or equity markets that represent its investors best options for liquidity.

Businesses whose stars are hitched to variable prices, that are highly cyclical or dependent upon technologies, and that change frequently are generally poor candidates for highly leveraged capital structures. Others that are dependent on a small number of customers or on regulations that might change are at risk of having their cash flows interrupted. On the other hand, businesses with well-established franchises such as leading distributors, producers of leading brand products, or communications franchises have been successfully leveraged repeatedly, as have the leading producers of certain industrial products.

The leveraged model also has been successfully applied to underperforming

businesses, particularly ones with large asset pools that represent attractive collateral to lenders. In these transactions, the rewards are gained from improving the company's operating performance. During the LBO boom of the 1980s, many such opportunities were found within the highly diversified conglomerates that had grown up in the 1960s and 1970s. The aforementioned Gibson Greetings, purchased from the former RCA Corp., is a case in point. U.S. Can Company, the big success story in general packaging, was a captive can maker for Sherwin-Williams Co. before it was bought out and refocused as an independent company.

Finally, the leveraged model has been successfully applied to the purchase of diversified businesses that were subsequently broken up through sales of their component units. This can be a relatively high-risk and sophisticated game of arbitrage and, generally speaking, credit has not been available for this type of transaction since the collapse of Campeau Corp. empire in 1989 following its leveraged acquisition of Federated Department Stores, Inc. Reduced pricing in the M&A market also has hampered the execution of breakup deals.

But the most common LBOs are those like Widget Corp. in that they enjoy the characteristics of stability and predictability, with reasonable barriers to entry and balanced relationships with customers and suppliers.

A leveraged buy-out also must be financed in a manner that simultaneously will meet lenders' requirements and will produce the desired valuation for the prospective equity holders. While senior lenders are able to look to both collateral and available cash flow to retire their loans, subordinated noteholders, although interested in the asset pool, are, by virtue of their junior position, typically at risk. Hence, like the equity holders, they are focused on the cash flows and future values of the business.

Businesses with large asset pools often are believed to be attractive LBO candidates because of the availability of collateral and their ability to shelter income from taxes through depreciation and amortization. If, however, they are capital intensive and operate in a competitive environment, the lender's first claim on their cash flow can leave them at a competitive disadvantage in a weak operating environment if they cannot invest in internal operations and their competitors can. Nonetheless, such capital-intensive businesses as textile producers and railroads have been successful leveraged buyouts.

Non-asset-intensive businesses also can be successful LBO candidates. If margins are attractive and can be protected, lenders often will rely primarily on cash flows backed by the available assets and by pledges of stock. Many light manufacturers, particularly those that mainly design and assemble products from purchased components, are excellent LBO candidates. In a world of just-in-time inventory and rigid receivables collections, such companies may have relatively few assets but large cash flows. Certain specialty retailers fall into this category, as does Widget Corp.

As in any successful business, management is an essential ingredient of the leveraged acquisition. The common wisdom, which is also good wisdom, is that an incumbent management that knows the business probably is the best management. To focus the organization on retiring debt, management will need to implement policies that emphasize cash generation for debt retirement without compromising long-term investment. The team will need strong leadership to implement these policies and will need depth and capability in operations and finance. The chief

financial officer will need to think about the business strategically, not merely as an exercise in keeping score. The rules of the road are that management invest its own savings in equity along with the organizers'. If they are unwilling to do so, it's a signal not to acquire the business.

EQUITY INVESTORS

The private equity investors that organize leveraged acquisitions include:

- Firms that specialize in these investments and which manage investment funds organized specifically to make them
- Institutional investors in the private equity markets that organize some of their own acquisitions
- Individuals or significant private corporations controlled by individuals
- Management teams able to mount some personal capital for the required equity

I will focus on the firms that specialize in organizing and investing in LBOs because financing markets of the 1990s require a substantial equity component in each transaction.

The tasks of the LBO firms are to identify attractive candidates, negotiate and finance their purchase, oversee each acquisition, and, eventually, realize returns on the capital invested, a process referred to as exiting.

There are numerous approaches to identifying acquisitions. It is believed, for instance, that there are as many as 100,000 U.S.-based companies that have revenues of more than $10 million. Most are privately or closely held, meaning liquidity is an issue for their owners; and for many others that are publicly owned but have limited followings, being public offers limited liquidity at best. In a typical year, between 2,000 and 3,000 of these companies are sold to new owners.

Prospective acquirers can focus their efforts by industry, by the size of business and its stage of development, or by its operating characteristics, such as capital intensity, competitiveness, or a weak financial condition that offers turnaround potential.

Companies that are actively for sale often are represented by intermediaries. An intermediary may be an investment bank, a commercial bank, an accounting firm, an attorney, or a small firm specializing in M&A advice. It is not unusual for a business broker to intercede with the parties to provide an introduction for a fee. All of these and others are, therefore, sources of information that a business is for sale. Because sponsors of leveraged buyouts are acquiring businesses primarily to earn a return on their invested capital, their interests are likely to be based on size—how large or small a company can be and fit within a goal of acquiring a diversified portfolio of businesses—as well as operating characteristics and assessment of management.

The target company, once identified, may be open to a negotiation; that is, those who control it may have a price in mind. Or the intermediary may be offering the business for bid under a tight set of rules designed to obtain the best available price

and terms for the selling shareholders. Financing is among the primary issues the seller wants addressed. In particular, how does the buyer, a new company organized by the LBO firm with no meaningful assets and no prior business history, intend to pay for the purchase? Since the investment group will commit to a price before it has been able to obtain financing, its judgment about what price to pay is critical to success. If the price is too high, it may burden the company with too much debt or dilute equity returns.

Most investment groups prefer negotiated acquisitions because the process of give and take permits both parties to evaluate the availability of financing. The financing project runs concurrently with the buyer's due diligence investigation. The investment group tries to have the seller accept its offer on the condition that it obtain the financing. But the only condition most sellers will accept is that the business investigation is satisfactory to the buyer. While this may leave the buyer room to wiggle out if it cannot arrange financing, such an outcome could damage its reputation among deal sources. Its judgment whether the transaction can be financed is, therefore, critical.

Another reason buyers prefer a negotiated process to an auction is it affords an opportunity to evaluate management. Among the important considerations are management's history and track record, the depth of the system of internal controls, the nature of the dialogue between the CEO and CFO, and the quality and depth of people in the key functions. For most investment groups, and for most management groups, a meaningful ownership interest for the managers is a key to achieving common interests. Most investor groups ask the key managers to make a meaningful personal investment as the best means of securing common financial interests. In return for this investment, the group offers a disproportionate interest in the equity, and often an incentive interest tied to achieving financial results that exceed the forecasts on which the acquisition is based.

Early LBOs were organized around existing managements. Low prices and high leverage ratios allowed management, in effect, to lead the process, and these deals often were called MBOs or management buy-outs. Until well into the 1980s, most LBOs were announced in the name of management to provide assurances of continuity to suppliers and customers. However, as prices increased, as more equity was required, and as investor groups developed their own reputations, management became less important to the deal. In most auction processes, in fact, management is not allowed to compete and is forced to sit by until a winner is anointed.

Managers and investors are parties to a shareholders' agreement that establishes:

- The circumstances under which shares can be transferred, and to whom
- What happens to stock if a manager leaves
- Who participates in sales of stock, whether partial or complete, and whether public or private
- Who has the right to initiate such transactions

If issues of control emerge, this agreement is an essential document.

The investor group also must organize the governance of the newly acquired company. Usually it depends on some combination of formal board of directors

meetings and informal exchanges of information and discussion. Reserved for the board are such customary issues as compensation, capital investment, financing, refinancing, and changes in ownership. Issues of strategy and tactics at the operating level and how they are discussed depend on the style and type of relationships that evolve between the investor group and management.

Most lenders, senior or subordinated, do not join boards, preferring to rely on observation rights and the provisions of their formal agreements. In forming a board, then, the investor group typically will include two members of management, representatives from its own staff, and one or more outsiders who, it is believed, can help management with important operating issues.

The important facts of this form of organization and governance, those which differentiate it from its public and private cousins, are that the company is controlled by investors who have performed an extensive, on-sight investigation, talked with customers, and negotiated with management. They know the company well and are familiar with the critical decisions it faces. They have analyzed or developed a model for the future of the company and have a plan in mind for executing it. The investor group and the management invest in the ownership, and in the company's future, on the basis of the same business plan, and they have the same financial incentives. Finally, they have capitalized the company with a substantial amount of debt which must be retired by contract. This means, in effect, that all strategic efforts will be focused on generating cash from the existing portfolio of products and/or businesses.

To understand how an investor group looks at exiting its investments, one must know how the investor groups are organized. While there is no single model, investor groups dependent upon institutional capital have found themselves working under an increasingly common set of terms.

Most investor groups start by organizing investment funds. The fund is composed of commitments by institutional investors to provide their pro rata shares of capital to each acquisition organized by the sponsor group. The fund participants include such large institutional investors as insurance companies, state and local retirement systems, corporate pension funds, endowments, and others interested in the private equity market. They commit to the fund with the understanding that they will pay its manager, the sponsor, a fee to seek out and organize acquisitions and that the sponsor also will receive a share of the profits, which is generally called the override. The override traditionally has been up to 20 percent after providing the institution with a preferred return. The sponsor or general partner of the fund is required to invest at least 1 percent of the capital committed to the fund, although many invest much more.

The structure matches the sponsor's incentives to those of management. The sponsor has committed personal capital and has a success incentive structured similarly to the managers. The investment of the sponsor's own money also insures that the sponsor risks a loss. The fund typically has five years in which to invest its capital (the investment period) and another five to seven in which to return it. Capital not put to work during the investment period is returned.

The investor group's performance is measured by return on investment, calculated as the internal rate of return to investors on capital actually employed after fees, expenses, and override. Because investor groups must compete for funds in

the risk-capital segment of the financial markets, they must provide investors with returns well above the averages for other investment categories. If they do not, they will have difficulty raising additional funds at the end of each investment period.

The typical leveraged buy-out approaches its maturity as an investment in four to five years. If it is performing according to plan, it has retired sufficient debt and accumulated sufficient equity to slow the rate of appreciation in its equity value. As this point approaches, the investor group is motivated to liquefy its investment.

While there may be a number of alternatives for gaining liquidity, essentially, they boil down to:

- Selling the company
- Recapitalizing through another leveraged transaction
- Taking the company public

For the investor group, selling and recapitalizing are quite straightforward. Going public, however, is a much slower form of exit. To avoid the appearance of a "bailout," the investors normally will be restrained by the underwriters of the public offering from selling stock in the company's initial offering. After the company is public, U.S. securities laws limit the amount of stock that can be sold in the open market by insiders. Hence, the investor group either can await the opportunity to sell under a subsequent public offering or, if they have owned their stock for more than the three-year holding period required by securities laws, distribute the stock to the fund investors and permit them to make their own decisions.

The public offering therefore is a far slower form of exit than a sale or recapitalization. It is employed, nonetheless, as a means to reduce debt, and therefore risk, when the values available in the public market will result in denominating a significant gain for the investor group.

DRIVEN BY HIGHER INVESTMENT RETURNS

The modern leveraged buy-out has its roots in the owners of private companies, need for liquidity, and the inefficiency of fixing underperforming business units owned by diversified corporations. While its application was expanded to restructurings of large public companies during the 1980s, the LBO has moved back to its roots in the tighter, more disciplined capital markets of the 1990s. Its professionalization during the 1980s, however, has carried over.

The large pools of institutional investment capital that predominate today are happy with the disciplines imposed by the organizational form described in this chapter. They also like the consonance of interests that is required by the various structures and is not available to them in public companies. For these reasons, private equity investing in the form of leveraged acquisitions appears to be assured an important place in the asset mix of our financial institutions in the foreseeable future.

WHARTON REPROGRAPHICS

Matchmaking to Get Top Dollar for A Mid-Sized Company

Linda Mertz

Finding the buyer that's willing to pay the most requires a full-scale marketing plan that plays to the strengths of the selling business.

Every selling company faces a unique population of prospective buyers. The challenge to the owners and their advisers is finding the one that will pay the highest price and has the best chance of financing and closing the transaction. Making the right match requires execution of a full-scale marketing plan based on extensive research, experience, imagination, and judgment.

A comprehensive program for marketing a mid-sized seller is an action plan to secure the highest possible value in the merger market and a purchase price that exceeds the company's stand-alone valuation. If properly executed, it replaces guesswork and hit-or-miss negotiations with a systematic approach to striking a mutually rewarding deal.

A proper marketing program could hone in on synergistic buyers that can capitalize to the greatest extent on the unique characteristics of the seller company. However, the work also may determine that a financial buyer, an individual, or the company's management may be a more logical acquirer. Or the conclusion may be that there is more value in selling the business piecemeal than in selling it as a single entity.

Each of these prospective outcomes presents challenges to the adviser that is designing and managing the marketing program. If synergistic buyers are the primary targets, for example, the marketing plan requires identification of the niche businesses for which the selling company offers the greatest complementary attractions.

The professionally run project will thoroughly analyze the target and its industry, spotlight its most prized elements, identify the qualified buyers that are willing to

MAKING THE RIGHT MATCH

Who's going to pay top dollar for my company? Odds are that any seller that takes potluck and tests the market on its own isn't going to come up with a very happy answer. Finding the right buyer, who can make the best use of the selling business and is willing to pay a premium for its advantages, requires a highly focused marketing program.

A properly run program stakes out the best "buyer niches," which may range from strategic acquirers who can capitalize on synergies, market share expansion, or diversification of product lines, to financial buyers committed to investment for growth. The plan also will determine whether the rewards are higher by selling the company intact or in discrete parts.

The marketing program:

- Analyzes the target and its industry;
- Identifies its most appealing characteristics;
- Selects the likely buyers who will pay the most for these elements; and
- Systematically reaches potential acquirers to advise them of the target's availability.

pay the most for these advantages, and advise them of the firm's availability.

Synergistic benefits from a combination of companies can be achieved by blending one or more of several operating functions. There can be synergies in marketing, manufacturing, engineering, finance, and management, as well as in the implementation of a better strategic plan for the combined organization.

Based on the transactions my firm has done, our experience is that marketing synergies offer the least risk and greatest prospect for value enhancement for middle-market companies. Benefits are the greatest when the acquired products complement and flesh out the buyer's product line. Acquired products can be moved through the buyer's distribution channels, can bring the buyer geographical expansion in the markets it serves, and can even be rolled out nationally or internationally by the larger firm that is formed by the deal. Buyers may be willing to pay a handsome price for increased marketing clout.

But synergies in other areas can be just as important, and, at times, more important. In manufacturing, for example, there may be underutilized or excess capacity in an industry, notably one that is mature or in decline. A buyer could find it advantageous to buy a company in the same field, consolidate manufacturing operations for greater efficiency and scale, and possibly free up some of its other capacity for faster-growing, more profitable businesses.

If an acquirer wants to build on a company with a growing market of profitable products generated by creative engineering talent, considerable synergy can be realized. It has been our experience that engineers seem to be less willing to move geographically than marketing, financial, or general management personnel. Therefore, it is risky to expect to transfer an engineering organization to a new location intact without the loss of some key people and talent. This needs to be carefully evaluated. The warning is that the price may depend on the seller's ability to deliver top-notch people.

Financial-type buyers also form an important part of the prospective buyer list. My perception of financial buyers in the middle market is different from those that emphasize larger transactions. Most middle-market financial buyers do not intend to build a portfolio of companies in which each is to be sold at a later date. The markets for buyers of middle-market companies are large and varied. There is a very big gray area between highly synergistic industry buyers and the pure financial buyer that offers nothing but money.

Financial buyers can bring synergies and other characteristics that are stimulative to the growth of the operation. It is not unusual for the middle-market company to have some underdeveloped functional areas. Manufacturing may be inefficient and outdated. Engineering units may not have the tools or the abilities to design new products. Sales and marketing may be reactive instead of proactive. Yet, the company continues to muddle along. A buyer with the skills to improve the neglected areas can be beneficial.

Strategies for Financial Buyers

An increasing number of financial buyers are taking a synergistic or strategic tack. Some are concentrating on defined markets, as opposed to highly diverse portfolios, and are looking for strategic additions for their existing business bases. But strategies vary. While some demand potential for high growth, others look for a sustainable market niche or leadership position with its potential for market power and consistent cash flow generation. It is not unusual for a financial buyer to pay a premium for entry to a market.

Frequently, values can be maximized if there is a prospect of restructuring a company. With the right marketing program, the seller may be able to capture the most benefits by restructuring itself as part of the sale.

We sometimes have concluded that the value of the individual parts of a target that we have represented is greater than the value of the company as a whole.

In those cases, we have sold divisions independently, or arranged for sales of discrete product lines with related inventory and usable equipment, and followed up by separately marketing the real estate and any remaining equipment. Considerable interest even can be generated among competitor companies that are interested in just customer lists and are willing to pay for the values received.

Competitive Juices

I believe that many owners and intermediaries do not recognize the values of the individual parts, especially in the middle market, and thus do not attain peak returns. Admittedly, segmented marketing may be more time consuming than a quick package sale. But we have found that many companies are liquidated as a whole at an inferior price when the separate aspects of the business could be sold at an aggregate premium.

Generally, the buyers that a sale-minded owner encounters by chance or finds through its own search are not the best. Acting individually, the target fails to stimulate the competition among prospective buyers that will surface the acquirer with the greatest cash resources and the motivation to pay top dollar. So, the seller may be shortchanging itself on two counts. First, by not zeroing in on the best synergistic fit and, secondly, by denying itself the incremental values resulting from competition among alternative buyers.

If systematic marketing offers the best opportunities for reaching synergistic benefits, how are market niches identified in the search for a complementary company that would profit the most by an acquisition? The process of identification requires an understanding of the company for sale and the markets it serves. Specific background information must be analyzed in terms of how the target can generate market share and efficiency for prospective buyers.

So, the first step in marketing a company is to fully appraise the company and its industry. A thorough analysis normally takes two to three months. It leads to a comprehensive written appraisal that provides the ownership with a documented opinion on the value of the company.

The review frequently includes an assessment of the various buyer niches, such as the exact markets in which the likeliest buyers compete and the types of prospective acquirers that could be expected to bid. This includes the estimated depth of each niche; the number and strength of the current players; growth prospects; economic, competitive, and financial conditions; and which prospective buyers could benefit most from a timely acquisition.

Following the client's review and input, the study results serve as the documentation necessary to prepare and distribute an offering document to prospective buyers. If we plan to contact direct competitors, we generally prepare two documents. The one for competitors is more generic and omits certain sensitive data, such as descriptions of customers and suppliers. The other is more comprehensive and is designed to provide necessary background to a prospect that lacks direct industry experience. Some transactions in which we have participated illustrate the diversity in the universe of qualified buyers and why a marketing program is needed to sort out the best.

The target was $10 million-a-year manufacturer of hydraulic steering and engine controls for pleasure and work boats. At the time of sale, the market was depressed and operations were at break even, although a few years earlier the firm enjoyed profit margins of up to 25% of sales.

But the company enjoyed worldwide distribution and a strong market share which attracted buyers in its industry from many countries. Their recognition of value was higher than that of domestic bidders because of the expected advantages from international consolidation and full product offerings. The seller got a premium price from a company that enjoyed market leadership in a complementary product and had worldwide distribution.

Marketing synergies offer the least risk and the greatest prospect for value enhancement for middle-market companies.

As an aside, the market for a company this size is generally regional. A rule of thumb is that the larger the size of a seller company, the broader the geographical spread of buyers. However, there are exceptions to the rule, and in this case, the difference in proceeds to the seller was significant.

A manufacturer of lift tables and rotators wanted to sell but was too small for most industry buyers to consider. We determined that an individual with related

experience and a will to own a company offered the best buyer profile. A former corporate executive with skills to overcome manufacturing and marketing shortcomings became the new owner — again at a premium price.

This deal pointed up the value of having an extensive data base of qualified individual buyers when marketing middle-market companies of smaller size and limited product appeal.

A highly profitable distributor and remanufacturer of automotive transmission parts that served national and international markets was up for sale. Despite its overt advantages, there were some complex underlying problems. Because the company had significant goodwill value, the buyer had to be well financed. Asset-based financing would not provide much leverage because the value of the company was supported by cash flow far more than by tangible assets. Cash flow lending is scarce for middle-market transactions, especially when there is a complete change in management.

Generally, the buyers that a sale-minded owner finds by chance or through its own search are not the best.

The winning bid was submitted by a team consisting of a buyer with access to deep equity pockets and an individual with industry experience to manage operations.

Factors Affecting the Size of the Market

Obviously, it is desirable to have a large, well-qualified, and interested group of buyers for a seller to consider. Several factors serve as indicators of the size of the buyer population.

One is the size of the company. As noted earlier, small companies that are unable to provide much mass or financial impact may face limited buying interested unless they offer an exceptional fit. They also pose a potential managerial problem. In the typical small company, the owner also is the principal manager, and he or she may not want to stay with the business. There can be a real risk to the buyer if the deal requires installation of new management immediately.

Seller financing, generally regarded as a way of minimizing a buyer's up-front investment, can, however, serve a dual purpose by resolving the managerial succession problem. It can be a form of commitment by the seller that tends to assure or comfort a buyer that there will be a smooth transition. This broadens the market of prospective buyers and financiers. Banks and venture capital sources, deeply concerned about management quality, frequently require seller paper before committing to a deal. Conversely, a demand for all-cash at the closing shrinks the list of buyer prospects.

The Appeal of Size

A larger company with $30 million in sales and pretax profits of $3 million has critical mass that can be appealing. Management tends to be deeper and is not as closely tied to the owner as in a smaller firm. Business can continue uninterrupted should a key executive leave.

When companies have established, in-depth management, they are likely to draw a greater number of interested and experienced buyers that are prepared to act decisively. Indeed, the buying population may be spread worldwide, offering the chance to generate spirited competition among acquirers that sense the opportunity for a good fit.

Service firms and companies dependent on technology frequently face more limited markets because of the problems in retaining their most precious assets — their people. Skills required to run these businesses are not always readily transferable, and buyers fear they will be paying for talent that will disappear.

If the target has a history of operating and financial problems, the search may have to focus on buyers with the skills to stabilize and restructure the firm to make it profitable. There is, however, a growing number of turnaround buyers who specialize in acquiring underperformers, and they may be the primary objects of the search. Many seek excess assets that can be liquidated to provide cash to help fund a streamlined residual business. But if assets already have been squeezed, fewer buyers are interested. The best course for these hardest-to-sell firms may be a break-up, with the product lines sold separately to competitors.

Location of the target also is important. Some buyers have no interest unless the company is easily accessible from their home bases — like there and back in one day. Companies that are off the beaten track turn off some prospects because of inconvenient location.

Impediments to entry and sustainable advantage can be major advantages to a buyer. Industries vary. For example, unless the target enjoys unusual name recognition or prime locations, mid-sized retail operations don't command as many interested buyers as mid-sized manufacturing concerns.

High-growth industries attract buyers while low-growth industries face smaller markets. It is possible to overcome adverse factors such as ease of entry if the target sports a high-growth feature. For example, a small company serving the home health market, which is simultaneously consolidating and growing, can command a hefty premium because of the extraordinary industry growth.

There are many buyer niches, and understanding the underlying dynamics of each is important. Motivations and perspectives of value are diverse. The general ground rules and how each niche is approached can also vary, often dependent on the characteristics of the seller.

Generalized Identification of the Niches

The more obvious and most frequently identified clusters of buyers include:

- Direct competitors.
- Firms in related industries.
- General industry companies.
- Customers of the target that are perhaps seeking forward or backward integration.
- Suppliers to the target also looking for integration.
- Individual entrepreneurs with experience in the target's industry and financial backers.
- A management group.
- Financial buyers.
- Venture capital sources.

The search for niche players can be limited to domestic buyers or broadened to include foreign acquirers. Geographical scope is a function of the company's characteristics and the owner's desires.

The market, or the subsets cited above, should not be approached until the marketing plan embodies a well-conceived idea of the seller's values and goals. Unless the target is a sick company undergoing a fire sale, there usually is no urgency and there is ample time to think these issues through.

With this final piece of information, we can mount a focused and selective approach to the market. In some instances, such as when the company is highly desirable and has a strong market, the seller may wish to make contacts one at a time. If it is an extraordinary property, that may be the best way to go. In general, however, we do not recommend this approach, because it limits competition.

Our preferred approach is to develop a comprehensive data base of synergistic and financial buyers. Part of this data base is from our proprietary records and is custom developed to meet the specific needs of our client. This is an important part of the process and, when done properly, can be quite time consuming.

We frequently rank individual niches and even specific prospects, giving those with a greater likelihood of success a high level of personal attention. The general marketing effort typically is launched with a select mailing of brief letters designed to stimulate interest. We enclose our small brochure which helps establish our credibility and experience. We also indicate that we only work on a retainer basis, so our clients are dedicated sellers.

Follow-up phone calls are made, as appropriate. Prospects emerge. Each prospect has different views and prior experiences. Many in the middle market never have bought a company, and, therefore, need education. It is important to build a rapport and to establish a constructive working relationship.

It is possible to overcome adverse factors such as ease of entry if the target sports a high-growth feature.

The work put into the marketing program can take time but it can pay great dividends, even in some of the most unlikely cases. We once represented a business that was losing $1 million a year and, on the surface, was going to draw few takers. However, the marketing program identified the best buyer as a competitor that ultimately paid $18 million, or far in excess of underlying asset values. The appeal to the buyer was the opportunity to gain market share and operating efficiencies from a consolidation.

Identifying the best buyer prospects required up-front thought and planning implemented by considerable research and analysis. But successful deals like the one just described demonstrate that the rewards can be well worth the effort. ■

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WHARTON REPROGRAPHICS

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Rigging Takeover Defenses

Martin Sikora
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When the sharks are prowling, it's time to break out the shark repellent. That attitude has been adopted by hundreds of publicly held American companies and some in foreign lands over the last two decades as merger and acquisition activity intensified and hostile or unsolicited takeover offers became common. Responding to potential or actual takeover threats, these firms have adopted a bewilderingly wide assortment of antitakeover devices, collectively known as shark repellents. Specific techniques bear such colorful handles as poison pills, golden parachutes, staggered boards, and antigreenmail measures that have become fixtures in business argot.

Since they came into vogue, shark repellents have been among the most controversial storm centers in the business world. They have been reviled by institutional investors and advocates of a free market for corporate control as barriers to realization of full shareholder value through the sale of a company. Proponents, mainly from the corporate arena, support them as legitimate mechanisms to preserve shareholder value by preventing companies from being bought on the cheap. They have triggered reams of academic literature, clutches of legislative and regulatory initiatives, and bitter corporate governance battles. But do they work? Who knows.

The fact is that corporate defensive weaponry rarely has been tested directly in the courts or in the M&A marketplace. No poison pill has ever exploded in the face of an unwanted buyer. No staggered board has prevented an acquirer from taking control of an unwilling target. M&A professionals assert that no announced deal has ever been turned back because of the target's defensive strengths, although there is no count of the potential deals that fizzled at the idea stage because acquirers refrained from attacking armored companies.

Yet the debate continues to rage. In what has become an annual meeting ritual, institutional investors and dissident shareholders continue to press companies for repeal of existing takeover devices while refusing to vote for any new proposals that require shareholder approval. Court decisions not specifically centered on shark repellents sometimes have rendered them impotent, and even modern communications technology has negated them. Conversely, many companies that go public through IPOs or by being spun off by parents reach the markets with defenses already in place. But in perhaps the most ironic twist, several corporate defenses have been enshrined in state laws, which authorities claim actually have been effective checkmates to unwanted acquisitions. (See Chapter 45.)

Generally (and somewhat arbitrarily) shark repellents fall into three classifications:

Corporation Charter and By-Law Amendments. These include such mechanisms as staggered boards, fair-price provisions, and supermajorities to approve mergers and acquisitions. They need shareholder approval to become effective. While these provisions dominated the defensive scene in the early and mid-1980s, they have been rarely tried in subsequent years as institutional investors mustered greater voting power and intensified their opposition to antitakeover devices.

Financial Techniques and Changes in Capital Structures. The best known of these devices is the poison pill, which has become the most pervasive of all antitakeover weapons because it can be installed by directors without getting the go-ahead from stockholders. Other actions include increasing debt, changing pension provisions, and installing multiple classes of common stock, some of which require stockholder approval and some of which don't.

Structural and Strategic Actions. These include a wide variety of techniques that change the looks or configuration of the company, the most extreme of which is the "scorched earth" dismemberment of the firm. Other initiatives to counter a hostile offer, such as finding a white knight buyer, also fall into this category.

POISON PILLS

Because of the realities posed by evolutions in corporate governance and in the M&A market, poison pills have become the defense of choice for American companies. They also have become the most pervasive antitakeover weapon—with an estimated 60 percent of major publicly held U.S. firms carrying them within their capital structures. Their adoptions continue because directors can install them on their own initiative and without risking rejection by shareholders.

What is a poison pill? Basically it is a right distributed to stockholders that allows them to buy additional shares under certain defined circumstances. In fact, most companies with pills polish their images by calling them shareholder rights plans or shareholder protection plans. There are several different types of pills, and the enumerated conditions and prospective outcomes vary from company to company. But the linkage is that they are activated by events that can lead to an unsolicited change in control of the company by a hostile acquirer. A hostile buyer, who typi-

cally is restrained from taking advantage of an activated pill, generally is defined as a bidder whose offer is not approved by the board. In many companies the bid must be blessed by two-thirds of the directors for it to become friendly. Conversely, a pill is redeemable in the event of a friendly acquisition.

There are several major variations.

Flip-in Pills

For openers, the flip-in right allows shareholders to buy additional stock in the company, but at an outrageous price far above prevailing market levels. However, the terms become far more attractive if the company is attacked and the pill comes alive. Most flip-in pills provide two major conditions for their being activated: a hostile bidder acquires a specified portion of the company's shares and/or launches a tender offer for a specified (and usually higher) percentage. For example, a pill may kick in if an unsanctioned bidder actually acquires, say, a 20 percent stake or if a tender offer is mounted for, say, at least 30 percent of the shares. These thresholds are called kick-in points.

If the pill kicks in (which has yet to happen), purchase of stock becomes more tempting. Some pills allow holders to purchase two shares at the originally excessive exercise price, while others may permit two shares to be bought at the prevailing market price for one share. The aim is to increase the number of outstanding shares that the acquirer must obtain and possibly raise the buyer's outlay.

Flip-over Pills

The flip-over pill in general has become a second line of defense. If the hostile buyer succeeds in getting control of the target, that company's shareholders have rights to buy stock in the acquirer at cut-rate prices. This too has never occurred. The purpose is to warn the buyer that it risks dilution of its own common share capitalization if the flip-over pill explodes.

The rights granted by most companies have both flip-in and flip-over provisions. If the flip-in doesn't work, the flip-over takes effect.

Flip-out Pills

The flip-out pill is largely a theoretical concept with no documented examples of actual adoption. When kicked in by a hostile offer, the right allows stockholders to buy shares in the target's subsidiaries and divisions. If the bidder obtains control of the target, it essentially owns an empty shell and not the firm's operations.

Back-End Pills

The back-end pill is one of several variations on the theme of loading up a company with debt to make it unattractive. If the back-end pill kicks in, debt securities are distributed to the shareholders. The buyer is supposed to be discouraged by the prospect of having to make good on the debts as the new owner.

Although among the most controversial defensive provisions, pills have been surprisingly resilient. Many companies have lowered the kick-in thresholds that were originally installed and have repeatedly renewed the purchase rights—which gener-

ally have life spans of 10 years—when they expire. While institutional investors constantly target them for rescission at annual meetings, their success rate is modest.

And the pills, while suffering some limited legal setbacks, generally have survived court battles. In what lawyers consider the most definitive ruling yet delivered, a flip-over pill was upheld—in a Delaware decision on a challenge to a flip-over installed by Household International. There has been no definitive or pervasive ruling as yet on flip-ins, but courts in specific cases have limited their applications. A pill was not allowed to block Grand Met's hostile acquisition of Pillsbury Co., and in another decision Interco Inc. was told that its pill could not be used to protect the company while it executed a leveraged recapitalization. Pills that lacked provisions for redemption also have been killed.

In a new guise, pills have become bargaining chips to appease unhappy shareholders. K-mart Corp. agreed to phase out a pill after its shareholders registered strong opposition to the purchase rights, and Westinghouse Electric, seeking an improved image in the face of poor performance, rescinded its pill.

POISON SECURITIES

Like poison pills, poison securities take on a new and deterring character when the company is under siege.

Poison Shares

During periods of tranquility, these shares, usually in the preferred stock class, may be nonvoting or have just one vote per share. Triggered by attack, they become supervoting securities with as much power as, say, 10 votes a share. A variation is to sell an outside investor shares with ordinary voting rights that increase in voting power if the company is attacked.

Poison Puts

Poison puts are attachments to bonds, debentures, notes, and other debt securities. Debt issues with them become callable if control of the issuing company changes hands and the new owner is required to pay them immediately. The first generation of puts make the debt securities immediately callable if the change in control is hostile. A later generation, called superpoison puts, makes the securities immediately callable on any change in control. These originally were not designed as antitakeover weapons but sprang from fears by debtholders that new owners might not be able to pay the attachments off.

CHARTER AND BY-LAW AMENDMENTS

Vehement institutional opposition has torpedoed new attachments of shark repellents to corporate charters and by-laws in the late 1980s and early 1990s, since they require shareholder approval. An exception has been the companies that reach the

public markets through IPOs and spin-offs with several of these provisions already on board. The menu includes the following.

Staggered Boards

Known legally as classified boards, these exist at companies that provide directors with three-year terms and put only a third of the board up for election by stockholders annually. The aim is to prevent a hostile acquirer that gains all or most of the shares from kayoing the board, the primary controller of company policy, with one blow. In practice, however, most boards will step out if a hostile bidder wins the battle.

Fair Price

The company in effect sets a minimum price that it considers acceptable and that has also been ratified by stockholders. The price generally is pegged to historical trading levels of the company's shares—that is, the average price over the previous five years or three years. Many fair-price provisions demand that if the offered price falls short of the mandated level, the acquisition must be approved by a supermajority vote (66⅔ percent, 75 percent, or more) of stockholders.

Supermajority Votes

Any hostile bid, again not cleared by the board, must be okayed by a specified supermajority to take effect. Some companies require a supermajority vote even if the offer is friendly.

Stockholder Meetings and Written Consents

Under the once-obscure written consents procedure, shareholders may petition the company for special meetings to vote on issues or may even amend the charter or by-laws if they get enough votes by soliciting them from shareholders. Since this back-channel approach traditionally was too difficult and circuitous to succeed, many companies moved to knock it out. Either they specifically barred written consents or they required that shareholders present specific proposals only at regular annual and special meetings, and then only after giving the company notice. Moreover, many of these companies give the board sole authority to call meetings.

Ironically, written consents, as a by-product of communications technology and institutionalization of shareholders, have become an increased threat to incumbent managers and directors. Using electronic mail and fax machines, hostile acquirers are able to get enough votes to force special meetings simply by signing up a relatively few investors. This happened when Great Northern Nekoosa, which did not eliminate written consents, resisted Georgia-Pacific's acquisition offer. When Georgia-Pacific obtained enough written consents from institutional holders to press for a special meeting so it could present its bid to shareholders, Great Northern gave up the fight.

Directors Duties

Adopting what has been nicknamed the McDonald's amendment, some companies allow directors to consider a wide range of issues beyond purchase price in fielding acquisition bids. They include the impact of the deal on employees, customers, suppliers, relevant communities, and the environment, among other issues.

Antigreenmail

Intended to deter the common 1980s practice of fending off raiders by buying their shares at above-market prices, antigreenmail provisions are on the periphery of antitakeover devices. In the main, they require a board to get shareholder approval to repurchase a significant block of stock, such as 5 percent or more, at a premium. But this is a time-consuming process that can slow raiders who are really trying a quick hit aimed at greenmailing. The theory is that time is the enemy of a hot-money raider. But it may be irrelevant, since Congress has imposed an excise tax on greenmail to discourage the practice.

Director Status

Directors may be removed only for cause, and sometimes only by a supermajority vote. If vacancies on the board occur between annual meetings, they can be filled only by the board itself.

Reincorporation

Some companies reincorporate in a state with stiff antitakeover laws to ward off takeover threats.

CAPITALIZATION CHANGES

The company may erect defenses by inserting them in their capital structures. Most defenses deal with voting powers of stock and usually require stockholder approval.

Multiple Classes of Common

Takeover defense mavens claim that the only truly bulletproofed companies are those with two or more classes of common stock, each of which has different voting privileges. This arrangement is the device most detested by heavyweight investors.

Multiclass common cements voting power in the hands of insiders, and it is sufficient to repel any hostile bid. One class is superior to the other. For example, regular common stock may have 1 vote per share while another class may dominate with 10 votes per share. Or the common may not have any votes while the superior class is the only one that votes.

Companies installing a second class of common may sweeten the deal by boosting

the cash dividend for the lower-powered shares. But this is still the hardest sell of all. At the companies that have managed to get inferior voting classes past shareholders—such as Hershey Foods, Playboy, and Strawbridge & Clothier—there was enough insider voting clout to put the proposals across. These firms would seem to need an extreme defense the least. But many planned to use stock for acquisitions or new equity offerings and they feared their hammerlock control would be loosened. With a similar eye on the future, companies going public often start with a two-class equity structure.

Multivoting common remains highly controversial with a debate that ranges into governance issues and has drawn strong regulatory reactions. Congressional legislation is introduced every session to mandate "one share, one vote" for all public companies. The Securities and Exchange Commission tried to erase multivoting common but was aborted by a U.S. Appeals Court in Washington that ruled the SEC overstepped its authority. The SEC's rule would have prevented trading of multiple-class common shares in established public markets.

Phased-Voting Common

Voting power of the common stock increases with the amount of time it is held by an owner. When the investor originally buys the stock, it has one vote per share. But that is gradually increased—up to a maximum of four votes a share—over time, usually up to four years. The idea is that the long-term shareholder is least receptive to a hostile acquisition offer.

Blank-Check Stock

Directors vote a new issue of common or preferred stock with the terms and voting power to be filled in later. Presumably the blank-check shares can be kept in reserve and given enough power to thwart a hostile bid if needed.

FINANCIAL ENGINEERING

Financial engineering techniques may produce changes in the capital structure but they may not be permanent. They also may go beyond the capital structure in effecting change.

Leverage

Boosting a company's leverage is considered a time-honored way of fending off a raider. A debt-strapped firm is less attractive on the face and new owners get saddled with the bills.

There are a number of ways to increase debt. The most extreme is the leveraged recapitalization, which overhauls the capital structure so that it is top-heavy with debt as compared with equity. Usually, shareholders trade existing common stock

for a package that includes interest-yielding debt securities and new (stub) common. Special cash dividends also may be included in the deal. Theoretical supporters hold that leveraged capitalizations can offer stockholders superior value to the acquisition offer.

The leveraged recap straddles the line between pure financial engineering and structural change because the debt-heavy company usually has to sell assets to accelerate repayments.

Although widely publicized, recaps have been done by relatively few companies, most of which were trying to beat back unwanted acquisition offers. Some firms, including Owens-Illinois, CBS, and Kroger Co., have been successful. Others, notably Interco Inc., which was driven into bankruptcy, were dismal failures.

Short of a full or partial recap, a company may jack up its leverage by launching an ambitious debt-financed capital spending program or by borrowing to pay for a hefty special cash dividend.

Self-Tenders

Large-scale share repurchases, called self-tenders, have been frequent responses to hostile offers. They can channel cash to shareholders who accept the offers, usually priced at a premium to market; and by shrinking the number of outstanding shares, they can provide a boost for the stock price. They are also leveraged plays, since the company often borrows heavily to pay shareholders. Indeed, if the self-tender is large enough, its impact on the capital structure can resemble a leveraged recap.

In-House ESOPs

An employee stock ownership plan (ESOP), functioning as part of the company's pension and benefits program, holds a significant percentage of the shares—and sets up a blocking position to prevent an unwanted bidder from getting 100 percent control. The rationale is that employees, fearing loss of their jobs, will vote against acquisition. ESOPs of this type have been upheld by the Delaware courts, in a case involving a hostile offer for Polaroid Corp., with the proviso that they provide genuine economic benefits—such as lower overall benefit costs and better worker incentives—for the firm and its shareholders. However, some of their appeal was dimmed when Congress voted to provide traditional tax benefits only to ESOPs used to buy majority control of an operating business.

Pension Parachutes

Many target companies were attractive to buyers in the 1980s because they enjoyed overfunded pension plans. That could mean instant cash for the acquirer skilled in maneuvering within U.S. pension laws. The buyer can terminate the plan and harvest the excess funds as long as it provides an adequate substitute for covered employees.

Corporate responses effectively erased the economic allure of the well-heeled pension plan. One provision specifically barred the acquirer from getting its hands

on the fund. Another triggered an immediate boost in benefits for retired and existing employees if control of the company changed in hostile fashion. Congress later joined the parade by imposing a tax on any excess cash reverted to acquirers from termination of pension funds.

Severance Parachutes

The best-known and most controversial of severance payments is the golden parachute, which provides benefits to top executives losing their jobs if their companies are acquired. Extensions include silver parachutes for middle managers and tin parachutes for employees below the managerial ranks. (See Chapter 43.)

STRATEGIC AND STRUCTURAL DEFENSES

Strategic and structural defenses represent a catchall category involving a wide range of initiatives, many of which play on opportunities presented by the M&A market itself. A significant change in the company's looks, operations, or status usually results. Previously mentioned moves like leveraged recapitalizations and self-tenders also can be classified within structural change.

One common technique is to seek a white knight buyer, a more compatible buyer that will pay a higher price than the hostile bidder. A key variation is a management-led LBO of the target, in which management becomes its own white knight. Companies that prefer to remain independent, publicly owned concerns may opt for the white squire approach, in which an outside investor—a company, an investment fund, or a wealthy individual—buys a significant minority interest and agrees to side with management in opposing unwanted offers. The white squire thus gains a blocking position, and in many cases the investment also can be a source of cash for the company.

Steps that gut company operations to make them unattractive are more the stuff of fables than of actual usage. In fact, they have been rarely employed. Under the "crown jewel" strategy, the company sells at least one, and perhaps more, of its best businesses to keep them away from the hostile acquirer. A "scorched earth" policy, a near-liquidation, dramatically widens the divestiture mode by selling virtually all the company's operations and leaving a shell.

At the other end of the spectrum, the besieged company can use acquisitions as defensive tactics, although their effectiveness is dubious. With the "ugly duckling" acquisition, the target purchases a money-losing or poorly performing company to make itself look worse. Or the target can buy a business that competes with the acquirer to set up a possible antitrust conflict.

Perhaps the most romantic of all is the Pac-man defense, in which the target counterattacks the raider by launching a tender offer for its shares. This is a nice ploy for novelists but is seldom used on the M&A battlefield.